American Tax Club, Inc.

(AMERITAX)

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Annual Federal Tax Refresher Course

(AFTR)

Annual Filing Season Program (AFSP)

Domain 2 – Part 2: General Review of Tax Return Preparation

Domain 2 of the Annual Federal Tax Refresher (AFTR) Course reviews important concepts and guidelines to preparing individual tax returns.

Objectives

After completing Domain 2 Part 2, participants should be able to:

- Determine when Social Security benefits should be taxable
- Distinguish when retirement distributions might be taxable
- Determine when Unemployment and Alimony are taxable
- Determine where to report and tax 1099-K amounts
- Explain self-employment income and allowable deductions on Schedule C
- List requirements for the business use of home deduction

2.3 & 2.4 **Reporting and Taxability of Retirement Income Including IRAs**

Social Security Benefits

Social Security benefits, including monthly retirement, survivor, and disability benefits, might be taxable. Most taxpayers will receive Form SSA-1099, which will report the total benefits.

Several factors determine if any portion of the Social Security benefits are taxable. If the only income the taxpayer received during the tax year is Social Security benefits or equivalent railroad retirement benefits, the benefits might not be taxable and the taxpayer might not be required to file a tax return.

If a taxpayer received income from other sources, the benefits will generally not be taxable unless the taxpayer's modified adjusted gross income (MAGI) is more than the base amount for the taxpayer's filing status.

Calculating Taxable Portion of Social Security Benefits

To figure the taxable portion of the benefits, compare the base amount for the taxpayer's filing status with the total of:

1. One-half of the benefits
2. All other income, including tax-exempt interest

When making this comparison, do not reduce other income by any exclusion for:

- Interest from qualified U.S. savings bonds
- Employer-provided adoption benefits
- Interest on education loans
- Foreign earned income or foreign housing
- Income earned by bona fide residents of American Samoa or Puerto Rico

To figure the taxable portion of Social Security benefits, compare the base amount for the taxpayer's filing status. The base amounts are:

- $25,000 if filing Single, Head of Household, or Qualifying Widow(er)
- $25,000 if filing Married Filing Separately and lived apart from the spouse for all the tax year
- $32,000 if filing Married Filing Jointly

- $-0- if Married Filing Separately and lived with the spouse at any time during the year

IRAs, Pensions, and Annuities

Distributions from IRAs, pensions, annuities, and other retirement plans are usually reported to the taxpayer on Form 1099-R and might be fully or partially taxable.

Retirement income is generally classified as one of the following types:

- Pension
- Annuity
- IRA

Distributions from IRAs, pensions, and annuities are fully taxable if the taxpayer has no investment in the contract because any of the following situations could apply:

- Taxpayer did not contribute anything nor was considered to have contributed anything for the pension or annuity
- Employer did not withhold contributions from employee’s salary
- Taxpayer received all of their contributions tax free in prior years

If the taxpayer contributed after-tax dollars to his or her pension or annuity, the distributions are partially taxable. Tax will not be imposed upon the part of the distribution which represents a return of after-tax amounts paid into the plan.

If a distribution was made before the taxpayer reached age 59 ½, it is considered to be an early distribution. An additional 10% tax is imposed upon early distributions unless qualified for an exception.

Pension

A pension is generally a series of determinable payments made to a taxpayer after he or she retires from work. Pension payments are made regularly and are based on such factors as years of service and prior compensation. Disability pensions normally begin when a taxpayer is disabled before retirement age.

Annuity

An annuity is a series of payments under a contract made at regular intervals over a period of more than one full year. Annuities can be either fixed (under which the taxpayer receives a definite amount) or variable (not fixed). Taxpayers can buy the contract alone or with the help of their employer.

Pensions and annuities include the following types:

- Fixed-period annuities - Taxpayers receive definite amounts at regular intervals for a specified length of time.
- Annuities for a single life - Taxpayers receive definite amounts at regular intervals for life. The payments end at death.
- Joint and survivor annuities - The first annuitant receives a definite amount at regular intervals for life. After he or she dies, a second annuitant receives a definite amount at regular intervals for life. The amount paid to the second annuitant might or might not differ from the amount paid to the first annuitant.
- Variable annuities - Taxpayers receive payments that may vary in amount for a specified length of time or for life. The amounts received might depend upon such variables as profits earned by the pension or annuity funds, or cost-of-living indexes.

- Disability pensions - Taxpayers receive disability payments because he or she has retired on disability but has not reached the minimum retirement age.

Individual Retirement Arrangements (IRAs)

An Individual Retirement Arrangement, or IRA, is a personal savings plan that allows taxpayers to set aside money for retirement, while offering them tax advantages. Taxpayers might be able to deduct some or all their contributions to an IRA and could also be eligible for a tax credit equal to a percentage of their contribution. Amounts in an IRA, including earnings, generally are not taxed until distributed. IRAs cannot be owned jointly, but any amounts remaining in an IRA upon the taxpayer's death can be paid to a named beneficiary or beneficiaries.

There are four kinds of IRAs, each with different tax implications:

- Traditional IRA - Distributions from traditional IRAs are fully taxable unless nondeductible contributions have been made.
- Roth IRA - Distributions from a Roth IRA are tax-free and can be excluded from income if certain requirements are met.
- Savings Incentive Match Plans for Employees (SIMPLE) IRA - Generally, SIMPLE IRA contributions are not included in an employee's income when paid into an IRA and the distributions are fully taxable when the employee receives them in later years.
- Simplified Employee Pension (SEP) IRA - Generally, SEP IRA contributions are not included in an employee's income when paid into the IRA. Distributions are generally fully taxable when the employee receives them in later years.

Example:

Johnson did not have a retirement plan at her job. Every year she contributed $500 to a traditional IRA. Each year Johnson deducted her traditional IRA contribution from her income. This year, she received her first distribution from the traditional IRA which is fully taxable. Johnson will pay income tax on the distribution she receives (which represents the contributions she made and deducted) and the earnings on the contributions.

Retirement Income Reporting Statements

Payers of retirement income report benefits on various forms such as:

- Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- Form CSA 1099-R, Statement of Annuity Paid (civil service retirement payments)
- Form CSF 1099-R, Statement of Survivor Annuity Paid

General Information about Retirement Plans - Receiving Benefits from More than One Program

For taxpayers who received benefits from more than one program under a single trust or plan of his or her employer, such as a pension plan and a profit-sharing plan, figure the taxable part of each pension or annuity contract separately.

Section 457 Deferred Compensation Plans

Taxpayers who work at a state or local government or tax-exempt organization might be able to participate in a section 457 deferred compensation plan, if eligible. Eligible plans are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. Amounts deferred in an eligible state or

local government plan are taxed only when distributed from the plan, and only when made available to the taxpayer.

Disability Pensions

Generally, taxpayers who retire on disability must include in income any disability pension received under a plan paid for by the employer. Report taxable disability payments as wages on line 1 of Form 1040 or 1040-SR until the taxpayer reaches the minimum retirement age. Once the minimum retirement age is reached, payments received are taxable as a pension or annuity on Form 1040 or 1040-SR.

Retired Public Safety Officers

An eligible retired public safety officer can elect to exclude from income distributions of up to

$3,000 made directly from a government retirement plan to the provider of accident, health, or long-term disability insurance.

Withholding and Estimated Tax

The payer of the pension, profit-sharing, stock bonus, annuity, or deferred compensation plan withholds income tax on the taxable parts of amounts paid to the taxpayer. Taxpayers may choose how much to withhold, by filing Form W-4P. If no tax or not enough tax is withheld, it may be necessary for the taxpayer to pay estimated tax.

Generally, a mandatory 20% tax is withheld from an eligible rollover distribution paid to a taxpayer from an employer-sponsored plan. No tax is normally withheld on a direct rollover of an eligible rollover distribution.

Qualified Plans for Self Employed Individuals

Qualified plans set up by self-employed individuals are sometimes called Keogh or H.R. 10 plans. Qualified plans can be set up by sole proprietors,

partnerships (but not a partner), and corporations. Plans can cover self-employed persons, such as the sole proprietor, partners, and regular (common-law) employees.

Distributions from a qualified plan are usually fully taxable because most recipients have no cost basis. If the taxpayer has an investment (cost) in the plan, however, the pension or annuity payments from a qualified plan are taxed under the Simplified Method, covered later in this course.

Purchased Annuities

In most cases, the General Rule (covered later) is used to figure the taxfree part of annuity payments from a privately purchased annuity contract from a commercial organization, such as an insurance company.

Loans and Tax-Free Exchanges

If money is borrowed from the retirement plan, treat the loan as a nonperiodic distribution from the plan unless certain exceptions apply. Include in income all or part of the amount borrowed.

Tax-Free Exchange

No gain or loss is recognized on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. If, however, an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

Figuring Cost of Plan

Before figuring how much, if any, of a distribution from a pension or annuity plan is taxable, the cost in the pension or annuity must be determined.

The cost is the investment the taxpayer has made in the contract, and includes the total premiums, contributions, or other amounts paid. This

also includes employer contributions taxable to the taxpayer when paid. Cost does not include any amounts deducted or excluded from income.

From this total cost, subtract any refunds of premiums, rebates, dividends, unrepaid loans not included in income, or other tax-free amounts received by the later of the annuity starting date or the date on which the first payment was received.

The annuity starting date is the later of the first day of the first period for which a payment is received and the date the plan's obligations became fixed.

Designated Roth Accounts

The cost in these accounts is the designated Roth contributions included in income as wages subject to applicable withholding requirements. The cost also includes any in-plan Roth rollovers included in income.

Foreign Employment Contributions

If the taxpayer worked in a foreign country and contributions were made to his or her retirement plan, special rules apply in determining cost. See Publication 575.

Fully Taxable Payments

Generally, if the taxpayer did not pay any part of the cost of an employee pension or annuity and the employer did not withhold part of the cost from the taxpayer’s pay, the amounts received each year are fully taxable and must be reported as income on the tax return.

Taxation of Periodic Payments

If the taxpayer paid part of the cost of the pension or annuity, the part of the pension or annuity received which represents a return of the cost is not taxable. The rest of the amount received is generally taxable. Figure the tax-free part of the payment using either the Simplified Method or the

General Rule (both covered later). The annuity starting date and whether or not the plan is qualified determines which method to use.

- If the annuity starting date is after November 18, 1996, and payments are from a qualified plan, use the Simplified Method.
- The General Rule must be used if the annuity is paid under a nonqualified plan. It is not used if the annuity is paid under a qualified plan.
- If the annuity is paid under a qualified plan and the annuity starting date is after July 1, 1986, and before November 19, 1996, use either the General Rule or the Simplified Method.
- For taxpayers with more than one taxable pension or annuity, figure the tax-free part and the taxable part of each separately.

Exclusion Limit

The annuity starting date determines the total amount of annuity payments that can be excluded from taxable income over the years. Once the annuity starting date is determined, it does not change.

If calculating the taxable portion of annuity payments using the simplified method worksheet, the annuity starting date determines the recovery period for the taxpayer’s cost. That recovery period begins on the annuity starting date.

Exclusion limited to cost - If the annuity starting date is after 1986, the total amount of annuity income that can be excluded over the years as a recovery of the cost cannot exceed the total cost. Any unrecovered cost at the taxpayer’s (or the last annuitant's) death is allowed as a miscellaneous itemized deduction on the final return of the decedent.

Exclusion not limited to cost - If the annuity starting date is before 1987, the taxpayer can continue to take a monthly exclusion for as long as the annuity is received. For a joint and survivor annuity, the survivor can

continue to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than the cost.

Calculating Taxable Portion

Taxpayers should use either the Simplified Method or the General Rule to calculate the taxable portion of annuity payments.

The Simplified Method should be used if the annuity starting date is after November 18, 1996, and both of the following are true:

- Taxpayer receives pension or annuity payments from a qualified employee plan, qualified employee annuity, or a tax-sheltered annuity (403(b)) plan
- On the annuity start date the taxpayer was either under age 75 or entitled to fewer than five years of guaranteed payments

The General Rule is generally used to determine the tax treatment of pension and annuity income from nonqualified plans, or qualified plan if taxpayer is 75 or older on the annuity starting date and the annuity payments are guaranteed for at least 5 years. The General Rule generally can be used only for qualified plans if the annuity start date was after July 1, 1986, and before November 19, 1996. For more information on the General Rule, see Publication 939, General Rule for Pensions and Annuities.

Simplified Method

Under the Simplified Method, figure the taxable and tax-free parts of annuity payments by completing the Simplified Method Worksheet, available in IRS Publication 575, which divides the cost by the total number of anticipated monthly payments.

Cost ÷ Number of monthly payments = monthly tax-free portion

For an annuity that is payable for the lives of the annuitants, the number of payments is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Taxation on Nonperiodic Payments

Nonperiodic distributions are also known as amounts not received as an annuity and include all payments other than periodic payments and corrective distributions.

Examples of nonperiodic payments are cash withdrawals, distributions of current earnings, certain loans, and the value of annuity contracts transferred without full and adequate consideration.

The taxable amount of a nonperiodic distribution depends on whether it is made before the annuity starting date, or on or after the annuity starting date.

If it is made before the annuity starting date, its tax treatment also depends on whether it is made under a qualified or nonqualified plan. If it is made under a nonqualified plan, taxability depends on whether it fully discharges the contract, is received under certain life insurance or endowment contracts, or is allocable to an investment made before August 14, 1982.

The annuity starting date is either the first day of the first period for which an annuity payment is received under the contract, or the date on which the obligation under the contract becomes fixed, whichever is later.

Distribution on or after annuity starting date - If a nonperiodic payment is received from an annuity contract on or after the annuity starting date, all of the payment is generally included in gross income.

Distribution before annuity starting date - If a nonperiodic distribution is received before the annuity starting date from a qualified retirement plan, allocate only part of it to the cost of the contract. Exclude from gross income the part allocated to the cost and include the remainder in gross income.

Lump-Sum Distributions (For Participants Born Before January 2, 1936)

NOTE: The following information about lump-sum distributions applies only if the plan participant was born before January 2, 1936. If the plan participant was born after January 1, 1936, the taxable amount of this nonperiodic payment is reported as discussed earlier.

A lump-sum distribution is the distribution or payment in one tax year of a plan participant's entire balance from all of the employer's qualified plans of one kind (for example, pension, profit-sharing, or stock bonus plans). A distribution from a nonqualified plan cannot qualify as a lumpsum distribution.

Use Form 4972, Tax on Lump Sum Distributions, to figure the separate tax on a lump-sum distribution using the optional methods. The tax figured on Form 4972 is added to the regular tax figured on the taxpayer’s other income. This could result in a smaller tax than would normally be paid by including the taxable amount of the distribution as ordinary income in figuring regular tax.

The taxable portion of a lump-sum distribution can be treated in one of the following ways (if the taxpayer qualifies):

- Report the part of the distribution from participation before 1974 as a capital gain and the part from participation after 1973 as ordinary income.

- Report the part of the distribution from participation before 1974 as a capital gain and use the 10-year tax option to figure the tax on the part from participation after 1973.
- Use the 10-year tax option to figure the tax on the total taxable amount.
- Roll over all or part of the distribution, discussed later in this course. No tax is currently due on the part rolled over. Report any part not rolled over as ordinary income.
- Report the entire taxable part of the distribution as ordinary income on the tax return.

Taxable and Tax-Free Parts of the Distribution

The taxable part of a lump-sum distribution is the employer's contributions and income earned on the account. Recover the cost in the lump sum and any net unrealized appreciation (NUA) in employer securities tax free.

In general, the taxpayer's cost is the sum of:

- The plan participant's nondeductible contributions to the plan
- The plan participant's taxable costs of any life insurance contract distributed
- Any employer contributions that were taxable to the plan participant
- Repayments of any loans which were taxable to the plan participant These costs must be reduced by amounts previously distributed tax free. Capital Gain Treatment

Capital gain treatment applies only to the taxable part of a lump-sum distribution resulting from participation in the plan before 1974. The amount treated as capital gain is taxed at a 20% rate. Elect this treatment

only once for any plan participant, and only if the plan participant was born before January 2, 1936.

10-Year Tax Option

The 10-year tax option is a special formula used to figure a separate tax on the ordinary income part of a lump-sum distribution. The tax is paid only once, in the year the distribution was received, not over 10 years. This election can only be made once per taxpayer after 1986, and only if the plan participant was born before January 2, 1936.

IRA Rollovers

Most distributions received from an IRA before retirement age can be "rolled over" by depositing the distribution in another retirement plan or IRA (or depositing back into the same account) within 60 days. Most financial institutions can deposit distributions directly into another plan or IRA, in a trustee-to-trustee transfer. Usually if the distribution is deposited into an IRA within the 60-day limit, it is tax free. If the deadline is missed, taxpayers might owe tax and penalties on the distribution.

Review IRS Publications 590-A and 590-B for specific rules and requirements for IRAs and rollovers.

One-Rollover-Per-Year Rule

Prior to 2015, the IRS applied an IRA-by-IRA limit on the 60-day rollover which allowed only one rollover per IRA in a 12-month period. Individuals often used rollovers as a "temporary loan" which was to be repaid within 60 days; and often found themselves taking a distribution from another IRA in order to "repay" the first IRA within the 60 days, thus beginning a second 60-day period in order to pay back the "loan".

Starting in January 2015, the IRS began enforcing new rules which allow taxpayers to rollover only one distribution per year, no matter how many IRAs the taxpayer owns. This comes after a tax court ruling in the case of

Bobrow v. Commissioner, which expanded the interpretation of the once per-year rollover rules. The court determined that only one rollover is allowed every 365 days on an aggregate basis rather than an account-by account basis that had been previously used.

Aggregate of IRAs

The 12-month limit applies by aggregating, or combining, all IRAs owned by an individual, treating them as one IRA for the purpose of the rollover limit. These IRAs include:

- SEP
- SIMPLE
- Traditional
- Roth

Rollovers from traditional to Roth IRAs (conversions) are not limited, but may be subject to income tax, however the conversion will not be subject to the early distribution penalties.

Example:

Jessica has two traditional IRAs; IRA 1 and IRA 2. Jessica takes a $5,000 distribution from IRA 1 on March 15, 2021. In order to avoid tax and penalties, Jessica must pay back or "rollover" $5,000 into either IRA within 60 days.

Jessica cannot take a distribution from IRA 2 to pay back IRA 1 without paying taxes and penalties on the second distribution, even if paid back within 60 days. She must wait 365 days before taking another distribution from either IRA 1 or IRA 2.

ROTH Recharacterizations

Prior to the TCJA, a taxpayer could elect to recharacterize a contribution made to one type of IRA as having been made to a different type of IRA.

For tax years beginning after December 31, 2017, the rule allowing the IRA recharacterization from conversions no longer applies. A conversion from a traditional, SEP, or SIMPLE IRA to a ROTH IRA cannot be recharacterized. The new provision also prohibits recharacterizing amounts rolled over to a ROTH IRA from other retirement plans such as a 401(k) and 403 (b) plans.

Additional Taxes

Additional taxes are imposed on the early distribution of pension funds and on the failure to withdraw pension funds timely. In most cases, taxpayers are not subject to additional taxes if early distributions are rolled over, and the withdrawing of funds begins at a normal retirement age, in reasonable amounts, over the taxpayer's life expectancy.

Special additional taxes are taxes imposed on the following:

- Early distributions
- Excess accumulation (not receiving minimum distributions)

Early Distributions

Most distributions (both periodic and nonperiodic) from qualified retirement plans and deferred annuity contracts made before the taxpayer reaches age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that must be included in gross income.

For this purpose, a qualified retirement plan is:

- A qualified employee plan under section 401(a), such as a section 401(k) plan
- A qualified employee annuity plan under section 403(a)A tax-sheltered annuity plan under section 403(b) for employees of public schools or tax-exempt organizations, or

- An individual retirement account under section 408(a) or an individual retirement annuity under section 408(b) (IRAs)

In general, an eligible state or local government section 457 deferred compensation plan is not a qualified retirement plan and any distribution from such plan isn't subject to the 10% additional tax on early distributions. However, any distribution attributable to amounts the section 457 plan received in a direct transfer or rollover from one of the qualified retirement plans listed above would be subject to the 10% additional tax.

Distributions from Roth IRAs allocable to a rollover from an eligible retirement plan within the five-year period

If within the five-year period starting with the first day of the tax year in which the taxpayer rolled over an amount from an eligible retirement plan to a Roth IRA, he or she takes a distribution from the Roth IRA, the taxpayer might have to pay the additional 10% tax on early distributions. 10% additional tax must be paid on any amount attributable to the part of the rollover that was included in income.

The same rule applies to distributions from designated Roth accounts allocable to in-plan Roth rollovers within the five-year period.

Early Distribution Exceptions (Qualified Plans)

Distributions that are not taxable, such as distributions that you roll over to another qualified retirement plan, aren't subject to the 10% additional tax.

- There are certain exceptions to this 10% additional tax. The exceptions below apply to distributions from a qualified plan other than an IRA.
- Distributions made to your beneficiary or estate on or after your death.
- Distributions made because you are totally and permanently disabled.

- Distributions made as part of a series of substantially equal periodic payments over your life expectancy or the life expectancies of you and your designated beneficiary. If these distributions are from a qualified plan other than an IRA, you must separate from service with this employer before the payments begin for this exception to apply.
- Distributions to the extent you have deductible medical expenses that exceed 7.5% of your adjusted gross income whether you itemize your deductions for the year. For more information on medical expenses, refer to Topic No. 502.
- Distributions made due to an IRS levy of the plan under section 6331.
- Distributions that are qualified reservist distributions. Generally, these are distributions made to individuals called to active duty for at least 180 days after September 11, 2001.
- Distributions that are excepted from the additional income tax by federal legislation relating to certain emergencies and disasters.
- Distributions up to $5,000 made to you from a defined contribution plan or an IRA if the distribution is a qualified birth or adoption distribution.
- Distributions made to you after you separated from service with your employer if the separation occurred in or after the year you reached age 55, or distributions made from a qualified governmental benefit plan, as defined in section 414(d) if you were a qualified public safety employee (federal state or local government) who separated from service in or after the year you reached age 50.

Distributions made to an alternate payee under a qualified domestic relations order.

- Distributions of dividends from employee stock ownership plans.

Early Distribution Exceptions (Traditional IRAs)

Early distributions of taxable amounts from a traditional IRA should be included in gross income. Early distributions are also subject to an additional 10% tax, as discussed later.

Early distributions are generally amounts distributed from a traditional IRA account or annuity before the taxpayer is age 59½, or amounts received when retirement bonds are cashed before the taxpayer is age 59½.

Exceptions

There are several exceptions to the age 59½ rule. Even if the taxpayer receives a distribution before they are age 59½, they may not have to pay the 10% additional tax if they are in one of the following situations.

- The taxpayer has unreimbursed medical expenses for the taxpayer, spouse and dependents, which are more than 7.5% of their adjusted gross income.
- The distributions are not more than the cost of the taxpayer's medical insurance due to a period of unemployment. Conditions include job loss, receiving unemployment compensation for more than 12 consecutive weeks, and specific timing rules of the distribution as related to unemployment.
- The taxpayer is totally and permanently disabled.
- The taxpayer is the beneficiary of a deceased IRA owner.
- The taxpayer is receiving distributions in the form of an annuity.
- They can receive distributions from their traditional IRA that are part of a series of substantially equal payments over their life (or their life expectancy), or over the lives (or the joint life expectancies) of the

taxpayer and their beneficiary, without having to pay the 10% additional tax, even if they receive such distributions before they are age 59½. Taxpayer must use an IRS-approved distribution method and they must take at least one distribution annually for this exception to apply. The "required minimum distribution method," when used for this purpose, results in the exact amount required to be distributed, not the minimum amount.

- The distributions are not more than the taxpayer's qualified higher education expenses. Qualified higher education expenses are tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a student at an eligible educational institution.
- The taxpayer uses the distributions to buy, build, or rebuild a first home. The limit is

$10,000. First-time homebuyer is defined as a taxpayer who had no present interest in a main home during the two-year period ending on the date of the acquisition of the home which the distribution is being used to buy, build, or rebuild.

- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution. Distributions after September 11, 2001 must be made no earlier than the date of the order or call to active duty, and no later than the close of the active duty period. The active-duty period must be more than 179 days.
- The distribution is a qualified birth or adoption distribution, up to $5,000 per adoption or birth. The adoptee must be under 18 or physically or mentally incapable of self-support.

The distribution from an applicable eligible retirement plan must be made during the 1- year period beginning on the date on which the adoptee was born, or the date on which the legal adoption of the adoptee was finalized.

Reporting the 10% Additional Tax

Calculate the 10% additional tax on Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts if:

- The distribution is subject to the tax and distribution code 1 isn't shown in the appropriate box of Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., or
- One of the exceptions applies but the box labeled "Distribution Code(s)" does not show a distribution code 2, 3, or 4.

Form 5329 is not required if the distribution is subject to the 10% additional tax and a distribution code 1 shows in the appropriate box. In this case, enter the 10% additional tax on line 8 of Schedule 2 (Form 1040), Additional Taxes and write "No" on the dotted line next to that line.

Excess Accumulations (Insufficient Distributions) Qualified Plans

Payments received from qualified retirement plans must begin no later than the required beginning date and the payments each year cannot be less than the required minimum distribution. These rules are in place to make sure that most retirement benefits are paid to the participant during the lifetime of the recipient rather than to the beneficiaries after the recipient’s death.

If the actual distributions in any year are less than the minimum required distribution for that year, the taxpayer is subject to an additional tax.

The tax equals 50% of the part of the required minimum distribution that was not distributed. For this purpose, a qualified retirement plan includes:

- A qualified employee plans
- A qualified employee annuity plan
- An eligible section 457 deferred compensation plan
- A tax-sheltered annuity plan (403(b) plan for benefits accruing after 1986)

NOTE: The tax might be waived if the taxpayer establishes that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.

Unless the rule for 5% owners applies, the taxpayer must begin to receive distributions from a qualified retirement plan by April 1 of the year that follows the later of:

- The calendar year in which he or she reaches age 72
- The calendar year in which he or she retires from employment with the employer maintaining the plan

Some plans require distributions to begin by April 1 of the year that follows the year in which the taxpayer reaches age 72 even if he or she has yet to retire; 5% owners are required to begin receiving distributions by April 1 of the year that follows the calendar year in which he or she reaches age 72.

By the required beginning date, the taxpayer must either receive the entire interest in the plan or begin receiving periodic distributions in annual amounts calculated to distribute the entire interest over his or her life or life expectancy or over the joint lives or joint life expectancies of the taxpayer and a designated beneficiary (or over a shorter period).

Excess Accumulations (Insufficient Distributions) IRAs

Payments received from traditional IRAs must begin no later than the required beginning date and the payments each year cannot be less than the required minimum distribution. Generally, taxpayers must begin receiving distributions by April 1 of the year following the year in which they reach age 72 (70 ½ if taxpayer reached 70 ½ before January 1, 2020). The required minimum distribution for any year after the year in which you reach age 72 must be made by December 31 of that later year.

If the actual distributions in any year are less than the minimum required distribution for that year, the taxpayer is subject to an additional tax.

The tax equals 50% of the part of the required minimum distribution that was not distributed. For this purpose, a traditional IRA plan includes: • A traditional IRA with deductible and non-deductible contributions

- A SEP-IRA (Self-employed person IRA)
- A SIMPLE IRA

NOTE: The tax might be waived if the taxpayer establishes that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.

There are also limited exemptions listed in Revenue Procedure 92-10 in Cumulative IRS Bulletin 1992-1.

Reporting the 50% Additional Excise Tax

Calculate the 50% additional tax on Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts. To request a waiver, attach a statement of explanation and complete Form 5329 as instructed under Waiver of tax for reasonable cause in the Instructions for Form 5329.

Excess Contributions IRAs

An excess IRA contribution occurs if a taxpayer:

- Contributes more than the contribution limit.
- Make a regular IRA contribution for 2019, or earlier, to a traditional IRA at age 70½ or older.
- Make an improper rollover contribution to an IRA.

Excess contributions are taxed at 6% per year for each year the excess amounts remain in the IRA. The tax can't be more than 6% of the combined value of all a taxpayer's IRAs as of the end of the tax year. To avoid the 6% tax on excess contributions, the taxpayer must withdraw:

- the excess contributions from their IRA by the due date of their individual income tax return (including extensions); and
- any income earned on the excess contribution.

See Publication 590-A for certain conditions that may allow you to avoid including withdrawals of excess contributions in gross income.

Qualified Charitable Distributions from IRAs

Generally, a qualified charitable distribution is an otherwise taxable distribution from an IRA (other than an ongoing SEP or SIMPLE IRA) owned by an individual who is age 70½ or over that is paid directly from the IRA to a qualified charity. Qualified charitable distributions can satisfy all or part the amount of a taxpayer's required minimum distribution from their IRA.

Charitable distributions are reported on Form 1099-R for the calendar year the distribution is made.

Reporting a qualified charitable distribution

Report the full amount of the charitable distribution on the line for IRA distributions on Form 1040. On the line for the taxable amount, enter zero

if the full amount was a qualified charitable distribution. Enter "QCD" next to this line.

The taxpayer must also file Form 8606, Nondeductible IRAs, if:

- a qualified charitable distribution was made from a traditional IRA in which the taxpayer had basis and received a distribution from the IRA during the same year, other than the qualified charitable distribution; or
- the qualified charitable distribution was made from a Roth IRA.

2.5 **Reporting and Taxability of Unemployment Compensation**

Unemployment compensation includes amounts received under the employment compensation laws of the United States or of a state including:

- State unemployment insurance benefits
- Benefits paid to a taxpayer by a state or the District of Columbia from the Federal Unemployment Trust Fund
- Railroad unemployment compensation benefits
- Disability benefits paid as a substitute for unemployment compensation
- Trade readjustment allowances under the Trade Act of 1974
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act of 1974
- Benefits from a private fund if you voluntarily gave money to the fund and you get more money that what you gave to the fund

Amounts received as unemployment compensation must be included in gross income for Forms 1040 and 1040-SR, Schedule 1, line 7. Unless federal tax is withheld from payments, it is sometimes necessary for the

taxpayer to pay quarterly estimated tax payments. Generally, taxpayers should receive Form 1099-G showing the amounts paid and any amount of tax withheld.

2.6 **Alimony**

Before the TCJA was enacted, payments received as alimony and separate maintenance were considered income and the payor spouse could deduct these payments from gross income.

Under the new Act, the alimony deduction by payor and inclusion by payee has been suspended. For payments required under divorce or separation agreements executed after December 31, 2018, there is no deduction for payments as alimony; likewise, alimony received is not taxable income.

If a divorce or separation is executed on or before December 31, 2018, but later modified, the new TCJA rules can apply if the modification:

- changes the terms of the alimony or separate maintenance payments; and
- states that the alimony or separate maintenance payments are not deductible by the payer spouse or includable in the income of the receiving spouse.

2.7 **Reporting and Taxability of Form 1099-K**

A payment settlement entity (PSE) must file Form 1099-K, Payment Card and Third-Party Network Transactions, for payments made in settlement of reportable payment transactions for each calendar year. The American Rescue Plan Act (ARPA), P.L. 117-2, amended the reporting threshold amount to $600 or more (previously $20,000), with no minimum number of transactions (previously 200 transactions), effective for calendar years beginning after Dec. 31, 2021.

Basic Information on PSEs

A PSE makes a payment in settlement of a reportable payment transaction, that is, any payment card or third-party network transaction, if the PSE submits the instruction to transfer funds to the account of the participating payee to settle the reportable payment transaction.

A PSE is a domestic or foreign entity that is a merchant acquiring entity, that is, a bank or other organization that has the contractual obligation to make payment to participating payees in settlement of payment card transactions; or a third-party settlement organization (TPSO), that is, the central organization that has the contractual obligation to make payments to participating payees of third-party network transactions.

PSEs include payment services such as PayPal, Venmo, and CashApp. They also include online auction payment facilitators and marketplaces connecting independent sellers with customers, such as eBay and Etsy. Some gig-work platforms, including Uber, Lyft, and TaskRabbit, are either third-party settlement organizations or use them to pay gig workers. Cryptocurrency exchanges, such as Binance, Bittrex, and Coinbase, will also fall under this reporting requirement.

Note: Healthcare networks, in-house accounts payable departments, and automated clearing houses do not qualify as TPSOs and do not report under section 6050W.

A payment card is any card, including any stored-value card (having prepaid value, including gift cards), issued according to an agreement or arrangement that provides for all of the following.

- One or more issuers of the cards.
- A network of persons unrelated to each other, and to the issuer, who agree to accept the cards as payment.

- Standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept the cards as payment.

A third-party payment network is any agreement or arrangement that provides for the following.

- The establishment of accounts with a central organization by a substantial number of providers of goods or services who are unrelated to the organization and who have agreed to settle transactions for the provision of the goods or services to purchasers according to the terms of the agreement or arrangement.
- Standards and mechanisms for settling the transactions.
- Guarantee of payment to the persons providing goods or services (participating payees) in settlement of transactions with purchasers pursuant to the agreement or arrangement.

A third-party payment network does not include any agreement or arrangement that provides for the issuance of payment cards. “Unrelated” means any person who is not related to another person within the meaning of section 267(b) using the rules of sections 267(c) and (e)(3), and 707(b)(1).

Forms Required for PSEs

Taxpayers will report amounts from Form 1099-K on the appropriate schedule or form.

Self-employed individuals receiving Form 1099-K for credit card transactions, etc., will normally report on Schedule C, line 1 Gross Receipts.

Other business entities will normally report on their appropriate business tax form. 1120, 1120S, 1065, etc. Note that being a C corporation does not exempt the taxpayer from 1099-K reporting.

Taxpayers who receive Form 1099-K for virtual and cryptocurrency transactions will normally need to reconcile those figures on form 8949. Caution should be used to accurately report these transactions, as the 1099-K issuer will not know (or report) the nature of the transaction, nor the basis in the asset transactions being reported.

2.8 **Schedule C. Self-Employment Income**

Self-employed taxpayers must file Schedule C to report their profit or loss from a business. A taxpayer is considered self-employed if he or she is:

- Carrying on a trade or business as a sole proprietor
- An independent contractor
- A member of certain partnerships
- In business for himself or herself in any other way
- Single-member LLC
- Member of qualified joint venture

Self-employment can include work in addition to regular full-time business activities, such as certain part-time work done at home or in addition to a regular job.

For taxpayers who own more than one business, a separate Schedule C must be completed for each business.

2.8.1 **Gross Receipts**

Use Schedule C to report the following gross receipts:

- Income received from business activity
- Goods or services received through bartering
- Wages and expenses received as a statutory employee
- Income and deductions of certain qualified joint ventures

- Certain Forms 1099-NEC, Nonemployee Compensation
- Certain Forms 1099-K, Payment Card, and Third-Party Network Transactions

Statutory Employees

If the taxpayer received a Form W-2 with the "Statutory employee" box 13 checked, report the income and expenses related to that income on Schedule C. Because Social Security and Medicare tax should have been withheld from those earnings, no self-employment tax on these earnings is owed.

Note: If there was both self-employment income and statutory employee income, two Schedules C must be filed. Do not combine these amounts on a single Schedule C.

Businesses Owned and Operated by Spouses

A taxpayer and spouse who jointly own and operate an unincorporated business and share in the profits and losses ae considered partners in a partnership, whether or not there is a formal partnership agreement. Use Form 1065 instead of Schedule C in these cases, unless one of two exceptions applies.

Exception: Community Income

If you and your spouse wholly own an unincorporated business as community property under the community property laws of a state, foreign country, or U.S. possession, you can treat the business either as a sole proprietorship or a partnership. States with community property laws include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. A change in your reporting position will be treated as a conversion of the entity.

Exception: Qualified Joint Venture

A taxpayer and spouse who each materially participate as the only members of a jointly owned and operated business and file a joint return for the tax year can elect to be taxed as a qualified joint venture instead of a partnership. By making the election, the taxpayers are not required to file Form 1065 and will instead report the income and deductions directly on the joint return.

To make this election, divide all items of income, gain, loss, deduction, and credit attributable to the business between the taxpayer and spouse in accordance with respective interests in the venture. Each taxpayer must file a separate Schedule C or F. Each must also file a separate Schedule SE to pay self-employment tax, as applicable.

1099-NEC Income

Form 1099-NEC generally reports payments made in the course of a trade or business. Usually, payers will not issue Form 1099-NEC for payments less than $600; however, taxpayers must report all income earned as an independent contractor or from informal side jobs as self- employment income even if Form 1099-NEC is not received.

Payments reported on Form 1099-NEC and any other amounts received in trade or business should be included in gross receipts on Schedule C.

Material Participation

On Schedule C, taxpayers should indicate if they “materially participated” in the operation of the business. The taxpayer materially participated in the business if he or she was involved on a regular, continuous, and substantial basis in its operations.

For purposes of the passive activity rules, the taxpayer materially participated in the operation of this trade or business activity if they met any of the following seven tests.

- Participated in the activity for more than 500 hours during the tax year.
- Participation in the activity for the tax year was substantially all of the participation in the activity of all individuals (including individuals who did not own any interest in the activity) for the tax year.
- Participated in the activity for more than 100 hours during the tax year and participated at least as much as any other person for the tax year. This includes individuals who did not own any interest in the activity.
- The activity is a significant participation activity for the tax year, and taxpayer participated in all significant participation activities for more than 500 hours during the year. An activity is a "significant participation activity" if it involves the conduct of a trade or business, the taxpayer participated in the activity for more than 100 hours during the tax year, and the taxpayer did not materially participate under any of the material participation tests (other than this test 4).
- Taxpayer materially participated in the activity for any 5 of the prior 10 tax years.
- The activity is a personal service activity in which the taxpayer materially participated for any 3 prior tax years. A personal service activity is an activity that involves performing personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.
- Based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis for more than 100 hours during the tax year. Participation in managing the activity does not count in determining if taxpayer met this test if any person (except taxpayer) (a) received compensation for performing management services in connection with the activity, or (b) spent more hours during the tax year

than taxpayer spent performing management services in connection with the activity (regardless of whether the person was compensated for the services).

If the taxpayer did not materially participate in the business, the losses and credits from the business may be used, with certain exceptions, only against income from other passive activities. In that case, complete Form 8582, Passive Activity Loss Limitations, to figure the amount of the loss to enter on the Schedule C.

2.8.2 **Business vs Hobby**

Taxpayers should be aware of guidelines when determining whether engagement in an activity is a hobby or for profit, such as a business or investment activity.

In order to make this determination, taxpayers should consider the following factors:

- The taxpayer carries out activity in a businesslike manner and maintains complete and accurate books and records.
- The taxpayer puts time and effort into the activity to show they intend to make it profitable.
- The taxpayer depends on income from the activity for their livelihood.
- The taxpayer has personal motives for carrying out the activity such as general enjoyment or relaxation.
- The taxpayer has enough income from other sources to fund the activity
- Losses are due to circumstances beyond the taxpayer's control or are normal for the startup phase of their type of business.
- There is a change to methods of operation to improve profitability.

- Taxpayer and their advisor have the knowledge needed to carry out the activity as a successful business.
- The taxpayer was successful in making a profit in similar activities in the past.
- Activity makes a profit in some years and how much profit it makes.
- The taxpayer can expect to make a future profit from the appreciation of the assets used in the activity.

All factors, facts, and circumstances with respect to the activity must be considered. No one factor is more important than another.

The IRS considers an activity for profit if it makes a profit at least three of the last five tax years (including the current year) and at least two of the last seven years for activities that are primarily breeding, showing, training, or racing horses.

Taxpayers who realize a loss incurred in the operation of an activity or business are allowed to deduct the loss from income; however, if the business or activity is considered a hobby, taxpayers cannot use a loss to offset income.

Self-Employment Expenses

Certain allowable expenses incurred carrying out a trade or business can be deducted from the gross profits on Schedule C.

These expenses include but are not limited to:

- Car and Truck Expenses
- Contract Labor
- Depreciation
- Insurance Premiums
- Legal and Professional Fees

- Offices Expenses
- Rents
- Repairs and Maintenance
- Supplies
- Taxes and Licenses
- Utilities
- Business Use of Home
- Advertising
- Commissions and Fees

Car and Truck Expenses

Taxpayers who use a car or truck for business purposes can usually deduct car expenses. Generally, one of the two following methods can be used to calculate deductible expenses:

- Standard mileage rate
- Actual expenses

The standard mileage rate is a flat rate per mile that can be used to figure the deductible cost of operating a car or truck for business. For 2022, the standard mileage rate is 58.5 cents per mile, increased from 56 cents in 2021. If the standard mileage rate is used, actual expenses cannot be deducted for the same year.

In November of 2019, the IRS released Rev Proc 2019-46 to update standard mileage rules to comply with the Tax Cuts and Jobs Act (TCJA). This new revenue procedure provides rules for using optional standard mileage rates for calculating deductible expenses for automobile use for business, charitable, medical, and moving purposes. Rev Proc 2019-46 modifies and supersedes guidance from Rev Proc 2010-51.

For more information, review Rev. Proc 2019-46.

Listed below are some of the key modifications in Rev Proc 2019-46.

- Taxpayers cannot claim a miscellaneous itemized deduction using the business standard mileage rate.
- Taxpayers cannot claim parking and tolls attributable to the taxpayer's use of an automobile for business purposes as a miscellaneous itemized deduction.
- Taxpayers must reduce basis of automobiles used in business by the depreciation claimed or allowable for the automobile. If the business standard mileage rate is used, a per-mile amount will be depreciation claimed or allowable.
- Deductions for moving expense are not allowed unless the taxpayer is a member of the Armed Forces on active duty moving pursuant to a military order and incident to a permanent change of station.

If taxpayers do not use the standard mileage rate, they may be able to deduct actual expenses. Some taxpayers may qualify to use either the standard mileage rate or actual expenses and, in that case, it may be best to calculate both methods in order to optimize the deduction and use the most advantageous deduction.

Actual car expenses include:

- Depreciation (explained further in Section 2.8.7)
- Licenses
- Gas
- Oil
- Lease payments
- Insurance

- Garage rent
- Registration fees
- Repairs
- Tires

Other car expenses for parking fees and tolls attributable to business use are separately deductible, whether using the standard mileage rate or actual expenses.

If an automobile has been fully depreciated, taxpayers may continue to deduct other actual expenses while the car or truck is in service.

For more detailed information and stipulations, please reference IRS Publication 463.

In order to deduct expenses for a car or truck used for a business purpose, taxpayers must prove the expenses. Timely and accurate recordkeeping is required to support any deduction for expenses. Amounts deducted cannot be approximate or estimates. Written evidence is generally considered the most adequate way to keep records for car and truck expenses.

Written evidence should include the amount of the expenditure, the date of time of use, place or description of the expenditure, and business purpose and relationship. Written evidence should also include a detailed, written, daily mileage log. Generally, documentary evidence such as receipts, cancelled checks, or bills, is required to support deductions.

2.8.3 **Business Use of Home**

Self-employed taxpayers and partners may be able to deduct certain expenses for a part of their home used for business.

In order to deduct expenses for business use of the home, the taxpayer's home must be used as one of the following:

- Exclusively and regularly as taxpayer’s principal place of business for trade or business
- Exclusively and regularly as a place where the taxpayer meets and deals with patients, clients, or customers in the normal course of the trade or business
- A separate structure used exclusively and regularly in connection with a trade or business that is not attached to the taxpayer’s home
- On a regular basis for storage of inventory or product samples used in a trade or business of selling products at retail or wholesale
- For rental use
- As a daycare facility

If the part of the taxpayer's home used is a separate structure, qualifying for a home-office deduction for its use requires that the separate structure be used exclusively and regularly in connection with the taxpayer's trade or business. However, the structure does not have to be the taxpayer's principal place of business or where he or she meets patients, clients, or customers. Additional tests apply to an employee's use of part of his or her home for business purposes.

Exclusive Use Requirement

Deductions for expenses for any part of the home that is used for both personal and business purposes are not allowed. The general rule that applies to qualifying for a home-office deduction requires that the taxpayer use a specific area of the home only for the trade or business.

Thus, the general rule mandates that the portion of the home used:

- Be a specific area, i.e., a room or other separately identifiable space; and
- Must be used solely in the taxpayer's trade or business.

Despite the requirement for a specific area, the space used need not be marked off by a permanent partition. However, under the general rule requiring exclusive use, a taxpayer will not qualify for a home-office deduction if the area is used for both business and personal purpose.

Example: Patricia's Use Qualifies under Exclusive Use Requirement

Patricia, a partner, engages in the practice of law and uses a room in her home exclusively for writing legal briefs, preparing documents, and meeting with clients. The room is used for no other purpose. Since the room in Patricia's house is a separately identifiable space and is used only in her legal practice, it meets the exclusive use requirement and may qualify for a home-office deduction under the general rule.

Example: Benson's Use Does Not Meet Exclusive Use Requirement

Benson, who is self-employed, uses a room in his home to prepare tax returns for his clients. When he is not using the room to prepare tax returns, he and his wife use it as a place to watch television. Because the room Benson uses as his office is also used for personal purposes by the family as a TV room, Benson would not qualify for a home-office deduction; the room fails to meet the exclusive use requirement.

Exceptions to Exclusive Use Requirement

Although the general rule requiring exclusive use in a taxpayer's trade or business in order to take a home-office deduction for business use applies to all other uses, two exceptions to that exclusive use requirement exist. Those exceptions apply to the taxpayer's use of part of the home:

- For the storage of inventory or product samples: or
- As a daycare facility.

Except for these two uses, any part of the taxpayer's home used for business purposes must meet the exclusive use test in order to qualify for

a home office deduction. Let's consider the requirements that apply to each of these uses.

Storage of Inventory or Product Samples

In order for a taxpayer to be able to deduct expenses for the business use of his or her home for storage of inventory or product samples, without the need to satisfy the general rule requiring exclusive use of the space, the taxpayer (and the space) must meet all the following tests:

- The taxpayer sells products at wholesale or retail as a trade or business.
- The taxpayer keeps the inventory or product samples in his or her home for use in the trade or business.
- The taxpayer's home is the only fixed location of his or her trade or business.
- The taxpayer uses the storage space on a regular basis; and
- The space used by the taxpayer is separately identifiable and suitable for storage.

Use as Daycare Facility

The second exception to the exclusive use requirement normally applicable to taking the home office deduction for business use of a taxpayer's home applies to the taxpayer's use of space in the home for providing daycare. In order for a taxpayer to qualify for the daycare exception to the exclusive use rule, the taxpayer must: 1. Be in the trade or business of providing daycare for

- children
- persons age 65 or older, or
- persons who are physically or mentally unable to care for themselves; and

2. Have applied for, been granted, or be exempt from having a license, certification, registration, or approval as a daycare center or as a family or group daycare home under state law.

It is important to understand that in order for a taxpayer to qualify for the home-office deduction as a daycare provider even though the space is not used exclusively for business purposes, the taxpayer must meet both previous requirements. Thus, if the taxpayer's application was rejected or license or other authorization was revoked, the exception to the exclusive use rule does not apply.

Example:

Ana is licensed by the state to operate an adult daycare business. She provides care during daylight hours to persons age 65 or older in a large, airy room of her home. When the room is not being used for her adult daycare business, it is used by her and other family members as a television and game room. Even though the room Ana uses to conduct her adult daycare business is not used exclusively for the business, she may take a home-office deduction since operation as a daycare facility constitutes an exception to the exclusive use rule applicable to the home-office deduction for business use of a taxpayer's home.

Regular Use Requirement

In addition to the exclusive use requirement generally applicable to a taxpayer's ability to take a home-office deduction for business use of the home, the taxpayer must also meet the requirements that the space be used:

- For business on a regular basis; and
- In connection with a trade or business.

If either of these requirements is not met, no home-office deduction for business use is permitted.

In order for a taxpayer using part of his or her home for business purposes to qualify for a home-office deduction, the specific area of the home used for business must be used on a regular basis. Thus, space in a home that is used for business purposes only on an occasional or irregular basis would not qualify the taxpayer for a home-office deduction. In order to determine if part of a taxpayer's home is used on a regular basis for business purposes, all facts and circumstances surrounding the business use of the space should be considered.

Although the exclusive use rule and its exceptions are straightforward and simple to apply, the requirement that a taxpayer use the space on a regular basis in order to qualify for the home-office deduction is far less straightforward.

A taxpayer can generally rely on two types of information to prove his or her regular use of a home office for purposes of the deduction:

1. A contemporaneous log of time spent in the office; and
2. Documents corroborating time spent in the office, such as:

- emails sent,
- a guest log signed by clients, or
- telephone billing statements indicating the taxpayer made telephone calls from the home office during the times indicated in the log.

A taxpayer may maintain a home office as a place in which to engage in several types of activities. However, those activities may or may not entitle the taxpayer to a home-office deduction. It is important, in order for the taxpayer to qualify for a home-office deduction, that the home office be used in a trade or business. If the office is used for some function other than as a place in which to engage in a trade or business, including engaging in a profit-seeking activity that does not constitute a trade or business, no home-office deduction is permitted.

Example:

Julio retired last year and received a substantial early retirement buyout that he uses for investment purposes. Although he does not operate as a broker or dealer, he spends several hours each day in his home office reading financial periodicals, deciding on various strategies for increasing his wealth, and making trades for his own account. While Julio clearly is engaged in a profit-making activity and uses his home office to further that objective, the fact he is not engaged in a trade or business means that no home-office deduction is permitted.

Principal Place of Business Requirement

As noted earlier, in order for a taxpayer to be able to take the home-office deduction for business use of a home, the home office normally must be used exclusively and regularly as the taxpayer's principal place of business. We have already looked at the exclusive and regular use requirements and will turn our attention now to the principal place of business test.

A taxpayer may have more than one business location at which he or she engages in a single trade or business. Despite having multiple locations, however, a taxpayer may still qualify for a home-office deduction. Qualifying to deduct the expenses for the business use of a home under the principal place of business test requires that the taxpayer's home must be the principal place of business for the trade or business.

Making the determination as to whether the taxpayer's home is his or her principal place of business requires consideration of:

- The relative importance of the activities performed at each place where the taxpayer conducts business; and
- The amount of time the taxpayer spends at each place where he or she conducts business.

A taxpayer's home office qualifies as his or her principal place of business if the taxpayer:

- Uses the home office exclusively and regularly for administrative or management activities of the trade or business; and
- Has no other fixed location where he or she conducts substantial administrative or management activities of the trade or business.

If the taxpayer's home cannot be identified as the principal place of business after considering the relative importance of the activities performed in it and the amount of time spent there, and the home-office deduction is not otherwise allowed as a place to meet patients, clients, or customers or as a separate structure, no home-office deduction is permitted.

Administrative or Management Activities

Note that a home office may qualify as a taxpayer's principal place of business if it is used for administrative or management activities of the trade or business. But what constitutes administrative or management activities?

When performed in connection with the trade or business, the following functions are examples of administrative or management activities:

- Billing customers, clients, or patients
- Keeping books and records
- Ordering supplies
- Setting appointments
- Forwarding orders or writing reports

Exceptions to Principal Place of Business Rule

In certain limited cases, a home office may qualify for a home-office deduction even though the space used for the home office is not the taxpayer's principal place of business. Those exceptions apply to the following situations:

- Part of the taxpayer's home is used to meet with patients, clients, or customers; or
- The premises is a free-standing, separate structure that is used exclusively and regularly for the taxpayer's business.

IRS Publication 587 outlines the provisions for the home office deduction.

Figuring the Deduction

Taxpayers can use one of two methods to figure their home-office deduction:

- Regular Method (or Actual Expense Method)
- Simplified Option

Taxpayers using the regular method must determine the actual expenses of their home office. Generally, taxpayers who use the regular method base deductions on the percentage of the home used as the office in home. These expenses include items such as real estate taxes, mortgage interest, insurance, utilities, repairs, maintenance, and depreciation.

Regular or Actual Expense Method

The actual expense method of figuring a home-office deduction uses the actual expenses incurred by the taxpayer as the basis for determining the deduction allowable for business use of the taxpayer's home. Bear in mind when using the actual expense method to figure the home-office deduction that a taxpayer cannot deduct expenses for the business use of a home

incurred during any part of the year he or she did not use the home for business purposes.

Thus, a taxpayer who begins using part of his or her home for business purposes beginning on July 1st of the year and who qualifies for a home office deduction cannot consider expenses for the period prior to July 1st. Instead, the taxpayer may consider only those expenses for the period July 1 through December 31 in figuring the allowable deduction.

When using the actual expense method for figuring the home-office deduction for a client, a tax return preparer must determine:

- The nature of the expense; and
- The percentage of the home used for business purposes.

Nature of the Expense

When determining the nature of the taxpayer's expense, expenses are placed into one of the following three categories:

- Direct expenses
- Indirect expenses
- Unrelated expenses

Direct expenses are expenses applicable to and affecting only the business part of the taxpayer's home. Except for daycare facility expenses that may be only partially deductible as discussed later under Daycare Facility, these expenses are deductible in full, subject to any applicable deduction limit. (See Deduction Limit later in this unit.)

Examples of direct expenses that may be deductible in full, subject to the deduction limit, include expenses for:

- Painting
- Making needed repairs

- Cleaning carpets

The above direct expenses are only allowable when incurred in the area used for business purposes.

Indirect expenses are those expenses the taxpayer incurs for keeping up and running his or her entire home. Such indirect expenses are deductible under the home-office deduction in an amount based on the percentage of the taxpayer's home used for business purposes. Similar to direct expenses, the deduction of indirect expenses is subject to the applicable deduction limit.

Examples of indirect expenses that may be deductible in part, based on the percentage of the home used for business purposes and subject to applicable deduction limits, include expenses for:

- Insurance
- Utilities
- General repairs
- Homeowner association dues

The third category of taxpayer expenses, expenses that are unrelated, are applicable only to the parts of the taxpayer's home that are not used for business purposes. These unrelated expenses are not deductible.

Unrelated expenses incurred by a taxpayer whose business use of a home qualifies for a home- office deduction for direct and allocable indirect expenses include expenses for:

- Lawn maintenance
- Painting of rooms not used for business purposes

Such unrelated expenses are not deductible for purposes of the homeoffice deduction.

Although direct expenses attributable to business purposes are deductible under the home- office deduction irrespective of the percentage of the home actually used by the taxpayer for business purposes, indirect expenses are not. Instead, indirect expenses are deductible under the home-office deduction only in an amount equal to the total of such indirect expenses multiplied by the percentage of the home used for business.

Suppose a taxpayer's indirect expenses amounted to $5,000 and 10% of the home was used for business purposes. The amount of the indirect expense attributable to business purposes would then be $500. ($5,000 x 10% = $500)

Calculating Percentage of Home Used for Business

A taxpayer is permitted to use any reasonable method to determine the percentage of his or her home used for business purposes. Two methods commonly used for determining the applicable percentage of a home for purposes of the home-office deduction are:

1. Dividing the square footage of the home used for business purposes by the total square footage of the home; and

2. Dividing the number of rooms used for business by the total number of rooms in the taxpayer's home.

Percentage Based on Square Footage

To determine the percentage of a taxpayer's home used for business purposes based on square footage, simply divide the square footage of the space used for business by the square footage of the entire house.

Percentage Based on Number of Rooms

Determining the percentage of a taxpayer's home used for business purposes by dividing the number of rooms used for business by the total number of rooms in the house should be used only if the rooms in the house are all of approximately the same size.

To determine the percentage of a taxpayer's home used for business purposes based on the number of rooms in the house compared with the number of rooms used for business purposes generally produces approximately the same result. To make the calculation requires only that the number of rooms used for business be divided by the total number of rooms in the home.

Deductible Expenses for Home-Office Deduction

Expenses that are deductible under the home-office deduction fall into two categories and include the following:

- Expenses that are deductible by the taxpayer whether or not the taxpayer uses the home for business purposes, i.e., they are deductible by all homeowners; and
- Expenses that are deductible by the taxpayer only if the taxpayer uses the home for business purposes.

In addition to those expenses that are deductible by all homeowners, many additional expenses are deductible by homeowners who use their homes for business purposes. These are expenses that would not normally be deductible by the homeowner.

Principal among those expenses that are deductible by a homeowner who uses the home for business purposes, in an amount determined by the percentage of the home used for business, are the following:

- Depreciation
- Insurance
- Rent paid for the use of unowned property used in the taxpayer's trade or business
- Repairs
- Security system maintenance and monitoring expenses

- Expenses for utilities and services

Although these expenses are deductible by a taxpayer using his or her home for business purposes, it is important to keep in mind that only the business percentage of these expenses is deductible.

Deduction Limit

The home-office deduction is not unlimited. Instead, if a taxpayer uses the actual expense method for claiming a home-office deduction, the deduction of otherwise nondeductible expenses, expenses such as insurance, utilities, and depreciation allocable to the business, is limited to the taxpayer's gross income from the business use of the home minus the sum of the following:

1. The business portion of expenses the taxpayer could deduct even if he or she did not use the home for business purposes. Such expenses include mortgage interest, real estate taxes, and casualty losses attributable to a federally declared disaster area allowable as itemized deductions on Schedule A (Form 1040 or 1040-SR) or net qualified disaster losses of the taxpayer claims the standard deduction; and

2. The business expenses that relate to the business activity in the home but not to the home itself. Such expenses include the costs of business telephone, supplies, and equipment depreciation. A self-employed taxpayer should not include in the business expenses that must be subtracted from gross income the one-half of self-employment tax the taxpayer is permitted to deduct.

In applying the deduction limit to a taxpayer's home-office deduction, the depreciation deduction should be taken last. If the taxpayer's home-office deduction in any year is reduced by the deduction limit, the taxpayer may carry over the excess to the next year in which he or she uses the actual expense method in claiming a home-office deduction. The carried over

expenses are subject to the deduction limit for the year to which they are carried over, whether the taxpayer lives in the same home during that year.

Simplified Method

Instead of using the actual expense method of determining a taxpayer's home-office deduction, a simplified method, available for years beginning January 1, 2013 may be used. When calculating the home-office deduction using the simplified method, the deduction is equal to the area of the taxpayer's home used for a qualified business use (not exceeding 300 sq. ft.) multiplied by the prescribed rate. The current prescribed rate is $5, but the IRS and the Treasury Department may update the prescribed rate from time to time.

Election of the simplified method is irrevocable for the year made. The taxpayer's election of whether to use the actual expense method or simplified method is one that is made each year. The election to use the simplified method to figure the home-office deduction must be made on a timely filed, original federal income tax return.

Depreciation and Actual Expenses Related to Use of Home not Deductible

If a taxpayer elects to use the simplified method of determining the home office deduction, neither depreciation nor any actual expenses other than those not related to use of the home, may be deducted. Business expenses not related to the taxpayer's use of the home continue to be deductible.

If a taxpayer used the actual expense method to figure the home-office deduction in a previous year and has an expense carryover because the deduction was limited in that year, no portion of the carried-over amount may be deducted in any year in which the taxpayer uses the simplified method. In such a case, the taxpayer will continue to carry over the disallowed amount to the next year in which he or she uses actual expenses to figure the home-office deduction.

Special Rules Applicable to Simplified Method

Special rules apply to a taxpayer using the simplified method to determine the home-office deduction under certain circumstances. Those special rules are applicable in the case of:

- Shared use of a home
- Multiple qualified business uses
- Multiple homes
- Part year use or area changes

Gross Income Limitation

Somewhat similar to the deduction limit applicable to the actual expense method for determining the home-office deduction, a gross income limitation applies to the home-office deduction available under the simplified method. Under the gross income limitation applicable to the simplified method, a taxpayer's home-office deduction is limited to an amount equal to the taxpayer's gross income derived from the qualified business use of the home reduced by the business deductions that are unrelated to the use of the taxpayer's home.

Deducting and Recordkeeping

After qualifying for a home-office deduction and determining the deduction amount, a taxpayer must report the deduction on IRS Form 1040 or 1040-SR and retain sufficient evidence for a specified period to support it. In this unit, we will examine the rules related to where the expenses of a home office are deducted and the recordkeeping requirements applicable to taking and supporting such a deduction.

Expenses Deductible Only When Home is Used for Business

While the deductible expenses already discussed are deductible by a taxpayer whether the taxpayer's home is used for business, certain other

expenses are generally deductible only when the taxpayer's home is used for business purposes.

Those expenses that are deductible by a taxpayer using the actual expense method only to the extent related to the business use of the taxpayer's home include:

- Insurance
- Maintenance
- Utilities
- Depreciation of the home

Accordingly, the personal portion of any of these expenses remains nondeductible. If the taxpayer uses the simplified method of determining the home-office deduction, these expenses do not figure into the deduction allowed for business use of the taxpayer's home.

Where the taxpayer using the actual expense method deducts the business portion of the above expenses depends on the method used by the taxpayer to figure the deduction for business use of the home.

Actual Expense Method for the Self-Employed

A taxpayer who files Schedule C and claims a home-office deduction using the actual expense method should report the home expenses that would not be allowable if the home were not used for business on the appropriate lines of Form 8829. If these expenses exceed the deduction limit, the taxpayer should carry over the excess to the next year in which the actual expense method is used, and the carryover will be subject to the following year's deduction limit.

If the taxpayer files Schedule F, the otherwise nondeductible expenses for insurance, maintenance, utilities, depreciation, etc. should be included with the taxpayer's total business use of the home expenses on Schedule

F, line 32, and the notation "business use of home" should be entered on the adjacent dotted line.

Irrespective of how the taxpayer figures the home-office deduction, the taxpayer should deduct business expenses that are not for the use of the taxpayer's home on the appropriate lines of Schedule C or Schedule F in full. Since these expenses are not for the use of the taxpayer's home, they are not subject to the deduction limit for business use of the home expenses.

Record Keeping Requirements for Business Use of Home

Taxpayers are required to keep records that provide information needed to figure the deduction for business use of the taxpayer's home. Thus, a taxpayer should keep canceled checks, receipts, and other evidence of expenses he or she paid. In connection with the home- office deduction, the taxpayer's records must show the following information: • The part of the taxpayer's home used for business purposes.

• That the taxpayer used part of the home exclusively (unless its use constituted an exception from the exclusive use requirement) and regularly for business as:

a. The taxpayer's principal place of business, or

b. The place where the taxpayer meets or deals with clients or customers in the normal course of business.

In addition, the taxpayer must keep records to prove the home's depreciable basis, including records evidencing:

- When and how the taxpayer acquired the home
- The home's original purchase price
- Any improvements made to the home

- Any depreciation the taxpayer is allowed because of maintaining an office in the home

Taxpayers must keep the records required to support their deduction for business use of a home for as long as they are important for any tax law. Accordingly, applicable records should normally be kept until the later of:

- Three years from the tax return due date or the date filed
- Two years after the tax was paid

The simplified option can significantly reduce record keeping burdens for small business owners by allowing taxpayers to apply a prescribed rate by the allowable square footage of the home office instead of deducting the actual expenses. Using the simplified method does not change the criteria for who may claim a home office deduction.

Net Profit or Loss from Schedule C / Schedule SE

Any net profit or loss calculated on Schedule C should be reported on Form 1040, Schedule 1, line 3. These amounts should be included in gross income.

Schedule SE

Use Schedule SE (Form 1040 or 1040-SR) to figure self-employment tax for the taxpayer. Self- employment tax is comparable to the Social Security and Medicare tax withheld from an employee's wages. For more information about this tax see Publication 334, Tax Guide for Small Business.

NOTE: Statutory employees typically have Social Security and Medicare tax withheld from their earnings and therefore do not need to file a Schedule SE.

Form 1040 or 1040-SR and Schedule SE, Self-Employment Tax, must be filed if either:

- Net earnings from self-employment (excluding church employee income) were $400 or more
- Church employee income was received for $108.28 or more

A return must be filed for the self-employed individual when gross income is at least as much as the filing requirement amount for their filing status and age.

Example:

Antonio, a single taxpayer, works part-time as a retail clerk and also works for himself as a wedding photographer. In the tax year, he earned

$9,500 (after expenses) taking wedding photos. Antonio must file Form 1040 or 1040-SR, Schedule C, and Schedule SE.

Example:

Margaret received income as a statutory employee reported on a W-2 for her cosmetic sales, and 1099-NEC for her work maintaining the network at a local attorney's office. When filing her return, include one Schedule C for her IT contracting and one Schedule C for her cosmetic sales. She will also need to file Schedule SE to report Social Security and Medicare tax for her work as an IT contractor.

2.8.4 **Schedule C Record Keeping**

It is important for self-employed individuals to keep diligent, accurate records. Good recordkeeping can help taxpayers:

- Monitor progress of the business
- Prepare financial statements
- Identify the source of receipts

- Track deductible expenses
- Prepare tax returns
- Support items reported on their tax return

The taxpayer’s type of business may determine the type of records kept; however, the recordkeeping system should include a summary of all business transactions. This summary is usually made in the taxpayer’s books (accounting journals, ledgers, etc.). Books should show gross income, deductions, and credits.

As part of recordkeeping, it is important that a taxpayer retain support documents such as sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. Support documents help support entries on the taxpayer’s tax return. These documents should be kept in an orderly fashion and in a safe place.

Any record should be kept as long as they may be necessary for the administration of any provision of the Internal Revenue Code. Generally, taxpayers should keep records that support an item of income or deduction on a tax return until the periods of limitation for the return run out.

The period of limitations is the period of time in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. Review the table from IRS Publication 583 to see the period of limitations.

See the table below for the Period of Limitations.

If you… THEN the period is…

1. Owe additional tax and situations (2), (3), and (4), below, do not apply to you 3 years

2. Do not report income that you should report, and it is more than 25% of the gross income shown on the return 6 years 3. File a fraudulent return Not limited

4. Do not file a return Not limited

5. File a claim for credit or refund after you filed a return

Later of 3 years or 2 years after tax was paid

6. File a claim for a loss from worthless securities or a bad debt deduction 7 years

2.8.5 **Entertainment Expenses**

Prior to the TCJA, a taxpayer generally could deduct expenses for activities considered to be entertainment, amusement, or recreation if the expenses were related or associated with the active conduct of the taxpayer's trade or business. For amounts incurred or paid after December 31, 2017, deductions for entertainment expenses are disallowed.

The TCJA deemed entertainment expenses as nondeductible regardless of the relationship of the expenses to the business activity, including meals purchased during entertainment activities. There are a few exceptions outlined in Code Sec. 274(e) including:

- Expenses for goods, services, and facilities that are treated as compensation to an employee

- Expenses paid or incurred by the taxpayer in connection with the performance of services for another person, under a reimbursement or other expenses allowance agreement
- Expenses for recreational, social, or similar activities primarily for the benefit of the taxpayer’s employees, other than highly compensated employees

Businesses can still deduct 50% of amounts paid for meals associated with the active conduct of the taxpayer’s trade or business. For example, employee travel meals are still 50% deductible.

The TCJA did reduce the deduction for meals provided to employees for the convenience of the employer. Only 50% of those expenses are deductible, and after 2025 this deduction will be completely disallowed.

Generally, no deduction is allowed for the expense of any food or beverage unless:

- Such expense is not lavish or extravagant under the circumstances; and
- The taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages.

Temporary 100% Deduction for 2021 and 2022

The Consolidated Appropriations Act of 2021 (CAA) provides for a temporary exception to the 50% limitation for business meals provided by a restaurant. Qualified business meal expenses paid or incurred during in 2021 and 2022 are 100% deductible.

Restaurants includes businesses that prepares and sells food or beverages to retail customers for immediate consumption, regardless of if the food and beverage is consumed on the premises.

Restaurants do not include businesses that primarily sells pre-packaged food or beverages not meant for immediate consumption, including grocery stores, vending machines or kiosks, specialty food store, drug stores, convenience stores, and liquor stores.

An employer may not treat as a restaurant any eating facility on the business premises issued to provide meals to employees (excluded from income) or a facility treated as a de minimis fringe benefit, even if operated by a third party as a restaurant. The IRS issued Notice 2021-25 to provide guidance for the temporary 100% business meals deduction.

2.8.6 **Section 179 Expenses Limits**

Taxpayers can elect to recover all or part of the cost of certain qualifying property, up to a limit, by deducting it in the year they place the property in service. This is the section 179 deduction. Taxpayers can elect the section 179 deduction instead of recovering the cost by taking depreciation deductions.

To qualify for the section 179 deduction, property must meet all the following requirements.

- It must be eligible property.
- It must be acquired for business use.
- It must have been acquired by purchase.

Section 179 expenses limits have increased for tax year 2022. For property placed in service after December 31, 2021, the maximum amount that a taxpayer can expense under Code Section 179 is $1,080,000. In order to take advantage of the full deduction, the total cost of the assets placed in service cannot exceed $2,700,000. A dollar-for-dollar reduction in the maximum Section 179 deduction limit occurs as the total cost of assets placed in service exceeds $2,700,000.

Example:

In 2022, Olivia purchased several pieces of equipment for his business. He spent $3,000,000 on the equipment. Assuming all the equipment qualifies for the Section 179 deduction, Olivia can deduct a maximum of $780,000 as a Section 179 deduction on his 2022 tax return.

Total Cost of Section 179 Assets placed in service in 2022 – Limitation of total assets placed in service = Reduction in max Section 179 deduction

Expense Limit – Reduction Amount = Allowable Section 179 deduction

$3,000,000 - $2,700,000 = $300,000 Reduction Amount

$1,080,000 – $300,000 = $780,000 Allowable Section 179 Deduction

Expense Limit – Reduction Amount =

Allowable Section 179 deduction

$3,000,000 - $2,700,000 = $300,000 Reduction Amount

$1,080,000 – $300,000 = $780,000 Allowable Section 179 Deduction

The Act also made some changes in which property qualifies as "Section 179 property". Under the prior law property that qualifies for Section 179 expensing includes:

- tangible, personal property
- computer software
- qualified real property (qualified leasehold, restaurant, or retail improvement property)

In order to qualify for the Section 179 deduction property generally must be purchased for the use in the active conduct or a trade or business.

Under the TCJA, the definition of qualified real property has broadened to include certain improvements to nonresidential real property including:

- roofs
- heating, ventilation, and air-conditioning property
- fire protection and alarm systems
- security systems

Section 179 has also been amended to allow expensing personal property used in connection with lodging.

Property such as elevators, escalators, building enlargements, or property attributable to the internal structural framework does not qualify as Section 179 property.

2.8.7 **Depreciation**

Depreciation is the annual deduction allowed to recover the cost of certain property over its prescribed useful life. In order for the cost to be depreciated, it is generally required that the asset have a life of more than one year.

In order for an asset or property to be depreciated it must meet the following requirements:

1. The taxpayer taking the deduction generally must own the property
2. The property must be used in the taxpayer's trade or business or income-producing activity
3. The property must have determinable useful life
4. The property must be expected to last more than one year

Land is never depreciable. Land does not get used up, wear out, or become obsolete. The cost of land generally includes the cost of clearing, grading, planting, and landscaping. Although land itself cannot be depreciated, certain land preparation costs, such as landscaping costs, incurred in preparing land for business use, can be depreciated. These costs must be

so closely associated with other depreciable property that a life for them can be determined.

Example.

Jaime constructed a new building for use in his business and paid for grading, clearing, seeding, and planting bushes and trees. Some of the bushes and trees were planted right next to the building, while others were planted around the outer border of the lot.

If Jaime replaced the building, he would have to destroy the bushes and trees right next to it. These bushes and trees are closely associated with the building, so they have a determinable useful life.

Therefore, Jaime can depreciate them. Jaime will add the other land preparation costs to the basis of his land because they have no determinable life and are not able to be depreciated.

2.8.7.1 **Bonus Depreciation**

The Tax Cuts and Jobs Act allows for a 100% first year deduction for the adjusted basis for qualified property placed in service after September 17, 2017, and before January 1, 2023.

In later years, the first-year bonus depreciation deduction phases down:

- 80% for property placed in service after December 31, 2022, and before January 1, 2024
- 60% for property placed in service after December 31, 2023, and before January 1, 2025
- 40% for property placed in service after December 31, 2024, and before January 1, 2026
- 20% for property placed in service after December 31, 2025, and before January 1, 2027

This additional first-year depreciation deduction is allowed for both new and used property.

For certain aircraft and property with longer production periods, the deduction is allowed one additional year. The 100% deduction is allowed for assets placed in service after September 17, 2017, through December 31, 2023. Each of the dates for the reduction percentage listed above are increased by one year.

First-year bonus depreciation is schedule to sunset after 2026.

2.8.7.2 **Luxury Auto Limits**

The TCJA has substantially increased depreciation limits for passenger automobiles, trucks, and vans. For passenger automobiles placed in service after December 31, 2021, the maximum amount of allowable depreciation is:

- $11,200 for the year placed in service
- $18,000 for the second year in the recovery period
- $10,800 for the third year in the recovery period
- $6,460 for the fourth, fifth, and sixth years in the recovery period
- $6,460 for any year after the recovery period (for unrecovered basis)

If bonus depreciation is claimed, an additional $8,000 may be expensed arriving at a maximum first year deduction of $19,200 in 2022.

2.8.7.3 **Listed Property**

To avoid misuse of the depreciation deduction for assets that could easily be used for both personal and business use, specific rules and record keeping requirements have been set in place for this "Listed Property." Prior to the TCJA, listed property included the following:

- passenger automobiles

- property used for transportation
- property generally used for entertainment, recreation, or amusement
- computers and related peripheral equipment

The TCJA ended the inclusion of computers and related peripheral equipment as listed property. This change is effective for property placed in service after December 31, 2017.

If business-related use of a listed property is more than 50% in a tax year, the property can be treated the same as any other business asset. But if business-related use is less than 50%, the asset is not considered predominantly used in a business, and the ADS straight-line depreciation should be used to count the deduction. This is called the predominant-use test.

Because a listed property needs to pass the predominant use test to decide if it can be treated as other business assets, the user needs to maintain detailed records of the use of the listed property. An example would be a log of the mileage of a vehicle used for business. The record should also include the expenditure related to the asset, such as cost of the property, repairs, insurance, and others.

Review question for Domain 2 Part 2:

Alexander turned 70 ½ on July 15, 2022. When must he start withdrawing from his traditional IRA?

a) By December 31, 2022
b) By April 1, 2023
c) By December 31, 2024
d) By April 1, 2025

Review question for Domain 2 Part 2 – Answer keywords

a. By December 31, 2022

Incorrect. The SECURE Act changed the RMD age to 72 after 2019. Taxpayers must take their first RMD by April 1 of the year after they reach age 72. Alexander would only be 70 in 2022.

b. By April 1, 2023

Incorrect. The SECURE Act changed the RMD age to 72 after 2019. Taxpayers must take their first RMD by April 1 of the year after they reach age 72. Alexander would only be 71 in 2023.

c. By December 31, 2024

Incorrect. The SECURE Act changed the RMD age to 72 after 2019. Taxpayers must take their first RMD by April 1 of the year after they reach age 72. Alexander would be 72 in 2024, but he only has to take the first RMD by April 1, 2025.

d. **By April 1, 2025**

Correct. The SECURE Act changed the RMD age to 72 after 2019. Taxpayers must take their first RMD by April 1 of the year after they reach age 72. Alexander would be 72 in 2024, and he has to take the first RMD by April 1, 2025.