REG

1

Federal Taxation of Individuals

Module

1	Filing Requirements and Filing Status	3
2	Gross Income: Part 1	11
3	Gross Income: Part 2	29
4	Adjustments	39
5	Standard Deduction and Itemized Deductions	51
6	QBI Deduction and Additional Deductions	65
7	Tax Computations and Credits	73



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Filing Requirements and Filing Status

1 Individual Income Tax Formula

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

Gross income

< Adjustments >

Adjusted gross income

< Standard deduction > *Or* < Itemized deductions >

< Charitable contributions deduction >
(if standard deduction is taken)

< QBI deduction >

< Additional deductions >

Taxable income

Federal income tax

< Tax credits >

Other taxes

< Payments >

Tax due *Or* < Refund >

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Taxable income is the base for the individual income tax. The following is a more detailed list of the items included in the calculation of taxable income.

Components of Taxable Income	
Gross Income	
• Wages • Interest • Dividends • State tax refunds • Alimony received* • Business income • Capital gain/loss	• IRA distributions (taxable portion)* • Pension and annuity • Rental income/loss • K-1 flow-through income/loss • Unemployment compensation • Social Security benefits • Other income
< Adjustments >	
• Educator expenses* • IRA contributions (traditional) • Student loan interest* • Health savings account contributions • Moving expenses (U.S. armed forces and intelligence community)	• Deductible part of self-employment taxes • Self-employed health insurance • Self-employed retirement plan contributions • Penalty on early withdrawal of savings • Alimony paid*
Adjusted Gross Income	
< Standard Deduction > Or *< Itemized Deductions >*	
	• Medical and dental expenses* • Taxes (state and local)* • Interest expense (home and investment) • Charitable contributions* • Casualty/theft loss attributable to federal or state declared disaster* • Educator expenses (in excess of adjustment limit)*
< Charitable contributions deduction > (if standard deduction is taken)	
< QBI Deduction >	
< Additional Deductions >	
• No tax on tips • No tax on overtime	• No tax on qualified vehicle loan interest • Enhanced deduction for seniors
Taxable Income	

* Refer to topic coverage for further information regarding specific details, thresholds, and limitations.

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2 Filing Requirements for Individuals

2.1 Who Must File?

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

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

2.2 When to File

2.2.1 Due Date—April 15

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

2.2.2 Extension

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

3 Filing Status

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

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

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

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

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

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3.3 Married Filing Separately

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

3.4 Qualifying Surviving Spouse With Dependent Child

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

3.5 Head of Household

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

To qualify, the following conditions must be met:

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

3.5.1 A Qualifying Child

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

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

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

3.5.3 Dependent Relatives (Must Live With Taxpayer)

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

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

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



Pass Key

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

Widow/widower (qualifying surviving spouse) = Must be principal residence for dependent child for **whole** year.

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

4 Dependency Definitions

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

Qualifying Child
Close relative
Age limit
Residency and filing requirements
Eliminate gross income test
Support test

Or

Qualifying Relative
Support test
Under a specific amount of (taxable) gross income test
Precludes dependent filing a joint tax return test
Only citizens (residents of US/Canada or Mexico) test
Relative test Or **Taxpayer** lives with individual for whole year test

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

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Pass Key

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

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

4.1 Qualifying Child

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

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

1. **Close Relative**

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

2. **Age Limit**

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

3. **Residency and Filing Requirements**

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

4. **Eliminate Gross Income Test**

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

5. **Support Test**

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

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4.2 Qualifying Relative

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

1. **Support Test**

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

2. **Under Gross Income Limitation**

   A person may not be claimed as a qualifying relative unless the qualifying relative's gross income is less than $5,300 (2026).

   - **Definition of Taxable Income:** Only income that is taxable is included for the purpose of the gross income limitation.
   - **Nontaxable Income**

     — Social Security (at low income levels)

     — Tax-exempt interest income (state and municipal interest income)

     — Tax-exempt scholarships

3. **Precludes Dependent Filing a Joint Return**

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

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

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

5. **Relative**

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

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

   Or:

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

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

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4.3 Multiple Support Agreements

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

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

Example 1 Multiple Support Agreement

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

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

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

a. No one
b. Tim
c. Angie
d. Mike

Solution: Peter only meets dependency definition requirements for Angie.

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

4.4 Children of Divorced Parents

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

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MODULE

2 Gross Income: Part 1

REG 1

1 Gross Income Overview

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

1.1 Gross Income Definition

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

1.2 Determination of Amount of Income

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

Pass Key

Event		Income	Basis
Taxable	=	FMV	FMV
Nontaxable	=	None	NBV

Example 1 Noncash Income

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

Required: Determine the amount of income for the taxpayer.

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

1.3 Realization and Recognition

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

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

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Illustration 1 Recognition Concept

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

1.4 Timing of Revenue Recognition

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

2 Specific Items of Income and Exclusions

2.1 Salaries and Wages

Gross income includes many forms of compensation for services.

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

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2.2 Nontaxable Fringe Benefits

- **Life Insurance Coverage**

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

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

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

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

- **De Minimis Fringe Benefits**

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

- **Meals and Lodging**

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

- **Employer Payment of Employee's Educational Expenses**

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

- **Employee Adoption Assistance Program**

  For 2026, a taxpayer can exclude from taxable income up to $17,670 of qualified adoption expenses paid by an employer. The exclusion is phased out for taxpayers with modified adjusted gross income (MAGI) of $265,080–$305,080 (2026).

- **Dependent Care Assistance**

  Employees can exclude from gross income up to $7,500 of benefits paid or reimbursements by an employer for dependent care expenses. Qualifying dependents include dependent children under age 13 and a spouse or other dependent physically or mentally incapable of self-care.

- **Qualified Tuition Reduction**

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

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- **Qualified Employee Discounts**

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

  - **Merchandise Discounts**

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

  - **Service Discounts**

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

- **Employer-Provided Parking**

  The value of employer-provided parking up to $340 per month (2026) may be excluded. The exclusion is available even if the parking benefit is taken by the employee in place of taxable cash compensation.

- **Transit Passes**

  The value of employer-provided transit passes up to $340 per month (2026) may be excluded.

- **Qualified Non-Roth Retirement Plans**

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

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

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

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

  - **Benefits Received (Taxable)**

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

- **Flexible Spending Arrangements (FSAs)**

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

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

    Employees have the ability to elect to have part of their salary (generally up to $3,400 for 2026) deposited pretax into a flexible spending account designated for them. These deposits must be done via salary reduction directly by the employer, and the employee is not taxed on that income. The employee has the option to use the deposited funds to pay for qualified health care and/or qualified dependent care costs, and submits claims to the plan administrator for reimbursement.

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

    An employee generally must use the money in an FSA within the plan year. Funds not used within 2½ months after the year-end are forfeited. However, this grace period only applies if the employer amended the plan accordingly. Alternatively, the employer may amend the plan to allow an employee to carry over up to $680 per year (2026) to use in the following year.

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2.3 Interest Income

2.3.1 Taxable Interest Income

The items below represent taxable interest income:

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

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

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

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

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

Filing Status	Modified AGI (2026)
Single/head of household	$101,800–$116,800
Married filing jointly	$152,650–$182,650

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

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

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

2.4 Dividend Income

2.4.1 Source Determines Taxability

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

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

2.4.2 Taxable Dividends

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

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

2.4.3 Preferential Tax Rate for Qualified Dividends

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

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

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

2026 Taxable Income				
Tax Rate	*Single*	*Head of Household*	*Married Filing Jointly*	*Married Filing Separately*
0%	$0–$49,450	$0–$66,200	$0–$98,900	$0–$49,450
15%	$49,451–$545,500	$66,201–$579,600	$98,901–$613,700	$49,451–$306,850
20%	Over $545,500	Over $579,600	Over $613,700	Over $306,850

2.4.4 Tax-Free Distributions

The following items are excluded from gross income:

- **Return of Capital**

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

- **Stock Split**

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

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

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

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

- **Life Insurance Dividend**

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

2.4.5 Capital Gain Distribution

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

2.5 Gains and Losses on Disposition of Property

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

Amount realized
< Adjusted basis of assets sold >
Gain or loss realized

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2.6 IRA Distributions

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

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

2.6.1 Distributions From Traditional IRAs

- Distributions of principal (contributions) are taxable if the taxpayer took a deduction for the contribution when made.
- Distributions of earnings are always taxable, whether or not the taxpayer deducted the contribution when made.
- A distribution from a nondeductible, traditional IRA is allocated between principal (contributions) and earnings pro rata based on relative amounts in the IRA account at the time of the distribution.
- Taxpayers are required to start taking required minimum distributions (RMDs) by April 1 of the year after the taxpayer reaches age 73 (if born between 1951–1959) or age 75 (if born in 1960 or later).

2.6.2 Distributions From Roth IRAs

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

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

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Illustration 2 Automated Diagnostic and Validation Check: Gross Income

Mary, a CPA, is preparing the Year 1 federal income tax return for her client, Isabelle Irwin, who is 62 years old and single. Isabelle received a $20,000 distribution for her individual retirement account (IRA) during the current year. Her only other source of income for the year was interest and dividend income from a mutual fund.

Mary received the following messages in a software diagnostic report when she was preparing Isabelle's Year 1 federal income tax return:

Form 1040: Dividend Income	Box 49	Qualified dividends

The amount of the total ordinary dividends in Box 48 that are qualified dividends was not entered in Box 49. An amount must be entered in Box 49. If the amount of qualified dividends is zero, enter a zero (0).

Form 1040: IRA Distribution	Box 73	Type of IRA

No entry was made to identify the type of IRA in Box 73. The type of IRA needs to be selected from the options provided:

- Roth
- Traditional Deductible IRA
- Traditional Nondeductible IRA

Form 1040: IRA Distribution	Box 74	Date IRA was opened

The date the IRA was opened was incorrectly entered with only the month and day, but not the year. The year that the account was opened needs to be added.

Form 1040: IRA Distribution	Box 75	Date of distribution

The date the distribution was made was not entered in Box 75.

Action Needed:

Mary should enter the amount of the dividends that qualify for the preferential capital gains rates in Box 49, Qualified Dividends. This amount is provided in Box 1b of the Form 1099-DIV.

The tax treatment of the IRA distribution depends on the type of IRA, so Mary needs to select the appropriate type from the list provided in Box 73. If the distribution is from a Roth IRA, the tax preparation software needs the date the account was opened and the date of the distribution. This information is used to determine whether the distribution was made at least five years after the first day of the year in which the taxpayer made the first contribution to the account.

Because Isabelle is over age 59½, the distribution is a qualified Roth distribution that is 100 percent nontaxable as long as the five-year test is met. If it is not met, the contributions (principal) distributed are nontaxable, but the earnings distributed are taxable.

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Example 2 IRA Distribution

Facts: Sally opened an IRA when she was 55 years old and contributed $5,000. Several years later, when the account had grown to $8,000, she withdrew $6,000 to pay for a three-week European vacation.

Required: Determine the amount of Sally's taxable ordinary income from the IRA distribution under four different assumptions:

1. Traditional IRA, deduction was taken for the contribution
2. Traditional IRA, deduction was not taken for the contribution
3. Roth IRA, amount was withdrawn four years after the contribution
4. Roth IRA, amount was withdrawn six years after the contribution

Solution:

1. $6,000 taxable ordinary income

   Traditional IRA and Sally deducted the contribution, so both distribution of principal (contribution) and earnings are taxable. A distribution of any amount is 100 percent taxable.

2. $2,250 taxable ordinary income

   Traditional IRA and Sally did not deduct the contribution, so the distribution of principal (contribution) is not taxable. Distribution of earnings for a traditional IRA are always taxable. The $8,000 account balance consists of 62.5 percent principal (5,000 contribution / 8,000 total) and 37.5 percent earnings (3,000 earnings / 8,000 total), so 37.5 percent of the distribution is taxable. $6,000 distribution × 37.5% taxable portion = $2,250.

3. $1,000 taxable ordinary income

   The Roth IRA distribution was made before the account had been open for five years, so it is a nonqualified distribution. Distribution of principal (contribution) is not taxable but the earnings are taxable. A distribution from a Roth IRA is considered to come first from principal (contribution), then earnings, so the $6,000 distribution consists of $5,000 nontaxable principal and $1,000 taxable earnings.

4. $0 taxable ordinary income

   The Roth IRA has been open for at least five years and Sally is at least age 59½ (55 years old at contribution + Withdrawal six years later = 61 years old at time of distribution). The distribution is a qualified Roth distribution and neither the principal (contribution) nor the earnings are taxed.

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2.6.3 Penalty Tax (10 Percent)

Generally, a premature distribution before age 59½ is subject to a 10 percent penalty tax (in addition to regular income tax) if the individual has not met an exception.

2.6.4 Exception to Penalty Tax (Still Subject to Ordinary Income Tax)

There is no penalty if the premature distribution was used to pay:

- **Homebuyer** (first time): Distribution used toward the purchase of a first home within 120 days of distribution ($10,000 maximum exclusion)
- **Insurance**
  - Medical: If unemployed with 12 consecutive weeks of unemployment compensation.
  - Long-term care: Lesser of the actual insurance premiums paid, 10% of the present value of the nonforfeitable accrued benefit, or $2,600 (2026).
- **Medical** expenses in excess of percentage of AGI floor
- **Disability** (permanent or indefinite disability, but not temporary disability)
- **Education:** College tuition, books, fees, etc.
- **Adoption or birth** of child made within one year from the date of birth or adoption ($5,000 maximum exclusion)
- **Disaster:** Qualified natural disaster ($22,000 maximum per disaster)
- **Terminal** illness or death of account owner
- **Emergency** expenses (for personal or family emergency, up to $1,000 per year)
- **Domestic** abuse victims (lesser of $10,500 (2026) or 50 percent of retirement account)

2.6.5 Rollover From Traditional to Roth IRA

Taxpayers can transfer funds from a traditional IRA to a Roth IRA. The amount transferred is taxed as if it is a distribution: Contributions that were not deducted are nontaxable, and both contributions that were deducted and earnings are taxable ordinary income. However, the withdrawal from the traditional IRA is not subject to the 10 percent early withdrawal penalty if the taxpayer contributes the entire amount to a Roth IRA account within 60 days of the withdrawal.

2.6.6 Distributions From Trump Accounts

A Trump account is a tax-deferred investment account for children under age 18 with a valid Social Security number. It is treated as a traditional IRA but has separate limitations and restrictions until the year the child turns 18.

- No distributions are allowed before the calendar year in which the beneficiary turns 18.
- At age 18 or older, regular traditional IRA distribution rules apply, including penalty rules for premature distributions before age 59½.
  - Earnings are taxed at ordinary tax rates when distributed.
  - Contributions without "basis" (employer contributions and federal government pilot program contributions that are excluded from income) are taxed at ordinary tax rates when distributed.
  - Other contributions to a Trump account are nontaxable when distributed since no deduction was allowed at the time of the contribution.

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2.7 Annuities

An annuity is a contract between a taxpayer and an insurance company in which the taxpayer contributes a lump-sum payment (or series of payments) and in return receives regular annuity payments over time. There are two basic types of annuities: 1) fixed period annuities, in which payments are received over a fixed period of time; and 2) life annuities, in which payments are received over the taxpayer's lifetime.

Each annuity payment received by the taxpayer consists of return of investment (contributions), which are nontaxable, and earnings, which are taxed as ordinary income. How much of each annuity payment is nontaxable return of investment and how much is taxable earnings depends on whether the annuity is a fixed period annuity or a life annuity.

2.7.1 Fixed Period Annuity Payments

The annuity exclusion ratio, which is the portion of each annuity payment that is a nontaxable return of investment, is the original investment divided by the expected value of the annuity. For a fixed period annuity, the expected value of the annuity is the amount of each payment times the number of payments.

Example 3 Fixed Period Annuity

Facts: Zoe purchased an annuity for $60,000 that would pay her $750 per month for 120 months (10 years).

Required: Calculate the amount of the taxable portion of each annuity payment received.

Solution:

Expected value of the annuity: $750 monthly annuity payment × 120 months = $90,000

Annuity exclusion ratio: $60,000 original investment / $90,000 expected value = 66.7% return of capital

Taxable portion of each annuity payment:

100% − 66.7% = 33.3%

33.3% × $750 monthly payment = $249.75

2.7.2 Life Annuity Payments

For a life annuity, the number of annuity payments to be received is unknown, so taxpayers must use IRS life expectancy tables to determine the portion of each annuity payment that is a nontaxable return of investment. The original investment is divided by the appropriate factor from the IRS tables. The IRS factor represents the taxpayer's life expectancy at the time he or she starts receiving the annuity payments. The factor ranges from 360 months for taxpayers age 55 or under to 160 months for taxpayers age 71 or older. The portion of each annuity payment that is a nontaxable return of investment is the original investment divided by the IRS life expectancy factor.

If a taxpayer lives longer than the IRS estimated life expectancy, the entire amount of any additional payments received are taxable. If the taxpayer dies before receiving the expected number of payments, the remaining unrecovered investment is deducted on the taxpayer's final income tax return.

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Example 4 Life Annuity

Facts: John purchased an annuity for $60,000 that would pay him $600 per month for the rest of his life. John is 64 years old at the annuity start date, so the IRS life expectancy factor is 260 months.

Required: Calculate the amount of the taxable portion of each annuity payment received.

Solution:

Nontaxable return of capital: $60,000 original investment / 260 months = $230.77

Taxable portion of each monthly annuity payment: $600.00 − $230.77 = $369.23

What if John lived for 270 months? The last ten $600 monthly payments would be fully taxable because he has recovered all of his original investment over the first 260 months.

What if John died after 250 months? The remaining unrecovered investment of $2,307.70 ($230.77 × 10 months) is deducted on John's final income tax return.

2.8 State and Local Tax Refunds

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

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

Illustration 3 Nontaxable and Taxable State and Local Tax Refunds

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

2.9 Payments Pursuant to a Divorce

2.9.1 Alimony/Spousal Support Payments

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

- payments must be legally required pursuant to a written divorce (or separation) agreement;
- payments must be in cash (or its equivalent);

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- payments cannot extend beyond the death of the payee-spouse;
- payments cannot be made to members of the same household;
- payments must not be designated as anything other than alimony; and
- the spouses may not file a joint tax return.



Pass Key

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

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

2.9.2 Child Support

- **Nontaxable:** If any portion of the payments is fixed by the decree or agreement as being for the support of minor children (or is contingent on the child's status, such as reaching a certain age), such portion is not deductible by the spouse making payment and is not includable by the spouse receiving payment.
- **Payment Applies First to Child Support:** If the decree or agreement specifies that payments are to be made both for alimony and for support, but the payments subsequently made fall short of fulfilling these obligations, the payments will be allocated first to child support (until the entire child support obligation is met) and then to alimony.

2.9.3 Property Settlements (Nontaxable)

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

2.10 Business Income or Loss (Schedule C)

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

2.11 Rental Income

Net rental income or loss is calculated on Schedule E and reported as a single line item on Form 1040 (the specific line item is rental real estate, royalties, ...).

2.12 Unemployment Compensation

A taxpayer must include in gross income the full amount received for unemployment compensation.

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2.13 Social Security Income

A portion of Social Security benefits received may be taxable. Taxpayers must include in income either 50 percent or 85 percent of the lesser of: (a) Social Security benefits received or (b) excess modified AGI over the threshold. The applicable percentage (50 percent or 85 percent) depends on the taxpayer's modified adjusted gross income (MAGI).

- MAGI = AGI + Tax-exempt interest + 50 percent of Social Security benefits.
- Lower income: No Social Security benefits are taxable if MAGI is $25,000 or less ($32,000 MFJ).
- Middle income: Up to 50 percent of Social Security benefits received are taxable if MAGI is between $25,000 and $34,000 ($32,000 and $44,000 MFJ).
- Higher income: Up to 85 percent of Social Security benefits received are taxable if MAGI is more than $34,000 ($44,000 MFJ).

2.13.1 Modified Adjusted Gross Income

Modified adjusted gross income (modified AGI), or provisional income, includes the following items:

- Any income excluded because of the foreign-earned income exclusion.
- Any exclusion or deduction claimed for foreign housing.
- Any interest income from series EE bonds that was able to be excluded because of qualified higher education expenses.
- Any deduction claimed for student loan interest or qualified tuition and related expenses.
- Any employer-paid adoption expense that was excluded.
- Any deduction claimed for an annual (non-rollover) contribution to a traditional IRA.

2.14 Year of Death Income

A final income tax return is filed in the year of death. A personal representative (executor or administrator of the decedent's estate) will file the tax return for a single taxpayer, while a surviving spouse may file a joint return in the year of death. The final income tax return is due at the same time the decedent's return would have been due, generally April 15 following the year of death.

The decedent's income includible on the final income tax return is generally determined as if the person were still alive, with the taxable period ending on the date of death. The method of accounting used by the decedent before death also determines the income included and deductions taken on the final income tax return. Income earned or received after death is reported on the federal estate tax return.

2.14.1 Final Return for Cash Basis Taxpayers

- Only income items actually or constructively received before death are included on the final return.
- Only deductible items actually paid before death are included on the final return (exception for medical expenses).

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2.14.2 Medical Expenses for Decedent

If medical expenses for the decedent are paid out of the estate within one year after the date of death, an election can be made to treat all or part of the expenses as paid by the decedent when they were incurred.

The amount in excess of 7.5 percent of AGI can be deducted on the decedent's final income tax return if deductions are itemized.

2.14.3 Deduction for Losses

Net operating losses (NOLs) and capital losses can only be deducted on the decedent's final income tax return. Unused NOL or capital losses cannot be deducted on the estate's income tax return.

2.15 Taxable Miscellaneous Income

2.15.1 Prizes and Awards

The fair market value of prizes and awards is taxable income. An exclusion from income for certain prizes and awards applies when the winner is selected for the award without entering into a contest (i.e., without any action on the winner's part) and assigns the award directly to a governmental unit or charitable organization.

2.15.2 Gambling Winnings and Losses

- **Winnings:** Gambling winnings are included in gross income.
- **Losses:** Unless the taxpayer is in the trade or business of gambling (which follows specific reporting rules), the deduction for gambling losses is limited to 90 percent of the amount of the losses for the tax year and is only allowed to the extent of gambling winnings. Excess gambling losses cannot be carried forward to future years. Gambling losses include the expenses the taxpayer incurred in connection with the gambling activity. Gambling losses are deductible on Schedule A as an itemized deduction, so no deduction is allowed for taxpayers who take the standard deduction.

2.15.3 Damages Awards

To decide whether a damages award is excludable, one must determine what the damages were paid "in lieu of." Thus, if a damage award is compensation for lost profit, the award is *income*.

2.15.4 Punitive Damages

Punitive damages are fully taxable as ordinary income if received in a business context or for loss of personal reputation. Punitive damages received by an individual in a personal injury case are also taxable except in wrongful death cases where state law has limited wrongful death awards to punitive damages only.

2.15.5 Cancellation of Debt (COD) Income

If a taxpayer borrows money from a commercial lender and the lender later cancels or forgives part or all of the debt, the canceled debt is generally included in the taxpayer's income. However, if the forgiveness meets the exclusions below, the COD income is nontaxable:

- Discharge on account of death or disability
- Discharge pursuant to certain work-related programs
- Discharge due to bankruptcy or insolvency
- Discharge as a gift or inheritance

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Example 5 COD Income

Facts: Mary owes the bank $80,000 on an unsecured recourse note. She satisfies the note in full with a payment of $30,000. The bank accepts this payment and forgives the remaining $50,000 of debt.

Required: Determine Mary's taxable income as a result of the cancellation of debt.

Solution: The debt is unsecured recourse debt and none of the exceptions apply, so Mary has taxable cancellation of debt income of $50,000.

2.16 Partially Taxable Miscellaneous Items (Scholarships and Fellowships)

- **Degree-Seeking Student:** Scholarships and fellowship grants are excludable only up to amounts actually spent on tuition, fees, books, and supplies (not room and board) provided:
  - The grant is made to a degree-seeking student;
  - No services are to be performed as a condition to receiving the grant; and
  - The grant is not made in consideration for past, present, or future services of the grantee.
- **Non-degree-Seeking Student:** Scholarships and fellowships awarded to non-degree-seeking students are fully taxable at FMV.
- **Tuition Reductions:** Graduate teaching assistants and research assistants who receive tuition reductions are taxed on the reduction if it is their only compensation, but not if the reduction is in addition to other taxable compensation.

2.17 Nontaxable Miscellaneous Items

- **Life Insurance Proceeds (Nontaxable):** The proceeds of a life insurance policy paid because of the death of the insured are excluded from the gross income of the beneficiary.
  - The interest income element on deferred payout arrangements is fully taxable.
  - If the proceeds are used to pay for long-term care, accelerated death benefits received by an insured who is terminally ill (provided there is certification that the insured is expected to die within 24 months), is chronically ill, or requires assisted living are not taxable.
  - For policies issued after August 17, 2006, if the policy is company-owned (COLI), the employer beneficiary may exclude from gross income benefits received (no more than the total amount of premiums and other amounts paid by the policyholder). Any excess received beyond the amount of premiums and other amounts paid by the policyholder would be taxable. The gross income inclusion requirement for the COLI is not applicable, however, if proper notice and consent requirements are met and any of the following situations apply:
    - —The insured was a qualified highly compensated officer, director, or employee and a U.S. citizen or resident.
    - —Proceeds were paid to a member of the insured's family.
    - —The beneficiary is a family member or another individual (not the policyholder).
    - —The beneficiary is a trust for the benefit of the insured's family (or the estate of the insured).

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- **Gifts and Inheritances (Nontaxable):** Gross income does not include property received from a gift or inheritance; however, any income received from such property (e.g., interest income, rental income, etc.) after the property is in the hands of the recipient is taxable.
- **Medicare Benefits (Nontaxable):** Exclude from gross income basic Medicare benefits received under the Social Security Act.
- **Workers' Compensation (Nontaxable):** Exclude from gross income compensation received under a workers' compensation act for personal injury or sickness.
- **Personal (Physical) Injury or Illness Award (Nontaxable):** Exclude from gross income damages received as compensation for personal (physical) injury or illness.
- **Accident Insurance: Premiums Paid by Taxpayer (Nontaxable):** Exclude from gross income all payments received (even with multiple recoveries) if the individual paid all premiums for the insurance.
- **Foreign-Earned Income Exclusion:** Taxpayers working abroad may exclude from gross income up to $132,900 (2026) of their foreign-earned income. In order to qualify for the exclusion, the taxpayer must satisfy one of the following two tests:

  1. **Bona Fide Residence Test:** The taxpayer must have been a bona fide resident of a foreign country for an entire taxable year.
  2. **Physical Presence Test:** The physical presence test requires that the taxpayer must have been present in the foreign country for 330 full days out of any 12-consecutive-month period (which may begin on any day).

  Note: The foreign-earned income exclusion cannot exceed the taxpayer's foreign-earned income reduced by the taxpayer's foreign housing exclusion.

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Gross Income: Part 2

1 Business Income or Loss, Schedule C

Net income from self-employment is computed on Schedule C. The net income from the sole proprietorship is then transferred to Form 1040 as one amount.

Gross business income
< Business expenses >
Profit or loss

1.1 Gross Income

Items that normally would be revenue in a trade or business or other self-employed activity (such as director or consulting fees) are included as part of gross income on Schedule C.

- Cash = Amount received (cash basis)
- Property = Fair market value
- Cancellation of debt

1.2 Expenses

Expenses include items that one would expect to find in business, such as:

- Cost of goods (inventory is expensed when sold).
- Salaries and commissions paid to others.
- State and local business taxes paid.
- Office expenses (e.g., supplies, equipment, and rent).
- Actual automobile expenses (depreciation expense is limited to only that portion used for business) or a standard mileage rate (72.5 cents per mile for 2026).
- Business meal expenses are generally 50 percent deductible. Certain exceptions apply.
- Depreciation of business assets.
- Employee benefits.
- Legal and professional services.
- Bad debts actually written off for an accrual basis taxpayer only (the direct write-off method, not the allowance method, is used for tax purposes).

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- Interest expense on business loans (interest expense paid in advance by a cash basis taxpayer cannot be deducted until the tax year/period to which the interest relates). The business interest expense deduction is limited to the sum of:
  - business interest income;
  - 30 percent of adjusted taxable income (ATI); and
  - floor plan financing interest expense.

  ATI is taxable earnings before interest, taxes, depreciation, and amortization (EBITDA). Floor plan financing is debt that is typically used to acquire motor vehicles held for sale or lease where the debt is secured by the acquired inventory.

  Disallowed business interest expense can be carried forward indefinitely. The limitation does not apply if the taxpayer's average annual gross receipts are $32 million or less (2026) for the prior three taxable years.

1.3 Nondeductible Expenses (on Schedule C)

- Salaries paid to the sole proprietor (considered a withdrawal)
- Federal income tax
- Personal portion of:
  - Automobile, travel, and meal expenses
  - *Interest expense:* this may be reported as an itemized deduction if mortgage interest or investment interest is paid
  - *State and local tax expense:* report as an itemized deduction on Schedule A
  - *Health insurance of a sole proprietor:* although this is not reported on Schedule C as an expense, it is reported as an adjustment to arrive at AGI
- Bad debt expense of a cash basis taxpayer (who never reported the income)
- *Charitable contributions:* report as an itemized deduction on Schedule A
- Entertainment expenses

1.4 Net Business Income or Loss

1.4.1 Net Business Income Is Taxable

There are two federal taxes on net business income:

1. Income tax
2. Self-employment (SE) tax
   - An adjustment to income is allowed for one-half of SE tax (Medicare plus Social Security) paid. This allows the sole proprietor the ability to "deduct" the employer portion of the SE tax as an adjustment to gross taxable income (of which the net Schedule C amount is a part).
   - All self-employment income is subject to the 2.9 percent Medicare tax.
   - Up to $184,500 (2026) is subject to the 12.4 percent Social Security tax (so a total of 15.3 percent on self-employment earnings up to $184,500 (2026).
   - The SE tax is calculated on 92.35 percent of self-employment income.

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