



TCP

Tax Compliance and Planning

CPA Exam Review

2026
Edition

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Introduction

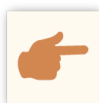
How to Best Use Your Course

Welcome to the UWorld CPA Review course! Our expert team is passionate about helping you succeed and has developed an award-winning program that is proven to yield results. Before you get started, please read through this guide on how to best use your course so that you can master all of the topics laid out for you in the AICPA Blueprints and ultimately pass the CPA Exam. At UWorld, our passion is to make the hard stuff easy to learn and understand.

Plan Your Studies

When preparing for the CPA Exam, half the battle is setting yourself up for success with a solid plan from the get go. This includes establishing short- and long-term goals to ensure you're staying on track.

To get started, use the Study Plan in your course. Start your plan by setting the beginning and ending dates for your schedule. Then select your pace (Fast Track versus Customize) and set the number of hours per day you will study. The system will create your plan based on your choices. It is important to follow your plan steadily so that you can ensure you hit your goals. If you miss a day, make it up!



Tip!

Download the app; this gives you access to everything your course offers even while on the go.

Master the Concepts through Active Learning

With this program, you will build your foundational knowledge and mastery of core exam topics through **active learning**. This evidence-based learning methodology centers around the principle that students retain information best when they actively participate in answering questions.

- **Begin with the Representative Task.** Read through each representative task carefully. (The Representative Tasks are from the AICPA Blueprints and are presented in our books and videos to guide you through the materials.) Pay particular attention to the words at the beginning of the task; they provide guidance on level and focus
- **Scan the book chapter.** Do you feel confident with the material? If you do, you might want to move directly to the questions and begin to practice. If you find that you are hesitant about an area, read the book or watch the video to solidify your understanding before you practice on some questions
- **Watch the videos.** If you prefer to absorb material on video rather than by reading the book, you will notice that the videos are deliberately set up in small segments. Our team created these segments so you can review what you need, either as part of the whole topic or for specific review of a smaller area
- **Practice the questions.** In our question bank (our QBank) we have taken great care to provide you with very high-quality questions and explanations. Each explanation not only tells you why the concept tested is important to understand but also teaches you why the answer is correct and why the other answer choices are not correct. Images, tables, definitions, and TBS Mastery videos also help fill in gaps as you use the questions and explanations to learn by doing

Track Your Progress and Performance

As you complete each chapter, track your progress and performance using our signature **SmartPath Predictive Technology™**. SmartPath is a data-driven platform that provides recommended targets based on those of previous students who have passed the CPA Exam. This is an important tool to help you study efficiently and gauge whether you are *exam-ready*. Your goal is to hit both your progress target (Questions Attempted) and performance target (Score) for each chapter.

As you work through the material, don't worry about hitting your "Score" target right away and focus your efforts on hitting the "Questions Attempted" target first. This approach may feel uncomfortable, but trust that you are building your knowledge as you absorb the answer explanations.

Once you've completed all the topics in a chapter, you can go back and focus your efforts on hitting the "Score" target. If you are falling short, drill down in the Performance tab to see which topics need extra attention.



Tip!

Don't over-study. **SmartPath™** helps determine when you can move on to the next topic.

Solidify the Concepts

Need extra help mastering the concept? Take advantage of the additional learning tools that are integrated into your course. For example, you could be working through a difficult question and find you need further explanation. No problem! There's a link to the supporting lecture right there in the question. Want to remember something for later review? You can easily transfer content directly from the question to a digital flashcard. These are just a few ways we make it easy for you to navigate to and access the right tools at the right time.

These additional tools are designed to enhance your studies—**you do not necessarily need to read or watch all of this material!** Rather, use these tools as a means to improve on any weak areas you might have:

- **Video Lectures** – From the Lectures tab or from the direct link at the bottom of each practice question, you have access to the profession's most motivating and effective lecturers. The lectures break down difficult topics into simplified concepts and provide helpful memory aids. These are especially recommended for visual and auditory learners
- **Textbooks** – The video lectures are accessible side by side with the digital eTextbooks or, in some of our course packages, a printed format. These guides can be used as a reference if you need further explanation of a concept. Many students also find it beneficial to follow along in the textbook while watching the lectures and taking notes, either directly in the physical books or by using the Notes feature and highlighting tool in the platform
- **Digital Flashcards** – Create custom flashcards directly from your practice questions by clicking on the lightning bolt symbol. Depending on your program package, your course may also be pre-loaded with an "Expert Deck" of flashcards covering the most heavily tested topics. You can review all your cards in Study Mode or by using our **spaced-repetition technology**. This is an evidence-based learning method that presents cards you've marked as *difficult* more frequently and cards you've marked as *easy* less frequently. The spacing of how and when the flashcards are introduced has been proven to increase retention and strengthen memory recall

Get Exam-Ready

The final days leading up to the exam are a critical time in which you're going to want to review your SmartPath data and ask, "Am I *exam-ready*?" If you have hit all the targets, you are in a really good spot. However, if any areas are still marked "Needs Improvement," now is the time to focus your efforts on meeting those targets.

We recommend you **take at least one full practice exam before exam day** (click on the "Exam Sim" tab in the QBank). This allows you to hone your test-taking skills in an exam-like environment that follows the same 5-testlet, 4-hour structure as the exam. The Exam Sim pulls questions from the QBank, and there is no limit to the number of times you can create an Exam Sim.

As a final step to assess your exam day readiness, we recommend you take the full-length mock exam. Curated with a unique set of questions not featured in the regular QBank, these practice tests are directly aligned to the content allocation and difficulty level of each CPA exam testlet. We recommend using this feature about 1–2 weeks before exam day.

AICPA Blueprints

The UWorld CPA Review course is based on the AICPA Blueprints, which show candidates what skills and content topics will be tested on the CPA Exam. You don't have to make tough decisions about what concepts to focus on. If you follow our methodology, you will be well on your way to passing the exam.

Let's take a look at what we mean by starting with the AICPA Blueprints. The Blueprints have four levels:

- Area
- Group
- Topic
- Representative Task

Each Representative Task also has a Skill level.

- Remembering & Understanding
- Application
- Analysis
- Evaluation (used only in AUD)

The Table of Contents of the book shows how each UWorld textbook is set up to follow the order of the AICPA Blueprints, with

- Area
- Group
- Topic

In the pages of each book, we provide the Representative Tasks from the AICPA Blueprints. We did that to make a direct connection between the exam and our content. Our team deliberately focused on what the Tasks say and wrote study materials that match with each Task. There is no closer connection between what will be tested and what you are studying.

Beyond connecting to the topics of the AICPA Blueprints, our team also differentiated the textbook content to match the Skill Levels of the Tasks.

- **Remembering & Understanding** tasks require you to understand the definitions and fundamentals of the topic. We have presented the information in these areas with an eye to creating clear explanations of the topics
- **Application** tasks are more about using your knowledge in scenarios to indicate that you understand the concepts. Our authors have therefore provided examples that show you how to apply your knowledge in specific situations. Many of these examples are similar to questions that you will find on the exam
- **Analysis** tasks require a higher level of thinking, many times requiring you to choose one outcome over another or to make a decision. On the exam, these tasks will always be addressed in Task-Based Simulations, or TBSs. The AICPA intentionally makes these more challenging to determine if you really know the material and can work with it as a professional. In our materials, our authors often guide you through the critical thinking required to work with TBSs
- **Evaluation** tasks are only in the AUD section of the exam and are at the highest level of thinking. They go a step further than the Analysis level and require you to evaluate or judge different approaches or outcomes

The CPA Exam

Within the AICPA Blueprints, there is information about how much time candidates have for each section and how many questions each section contains, categorized by question type. Question types include Multiple-Choice Questions (MCQs) and Task-Based Simulations (TBSs).

Section	Section Time	Multiple-Choice Questions (MCQs)	Task-Based Simulations (TBSs)
AUD – Core	4 hours	78	7
FAR – Core	4 hours	50	7
REG – Core	4 hours	72	8
BAR – Discipline	4 hours	50	7
ISC – Discipline	4 hours	82	6
TCP – Discipline	4 hours	68	7

Scoring Weight by Exam Section

The AICPA also shows candidates how the question types for each section are weighted and account for their overall score.

Section	Score Weighting	
	Multiple-Choice Questions (MCQs)	Task-Based Simulations (TBSs)
AUD – Core	50%	50%
FAR – Core	50%	50%
REG – Core	50%	50%
BAR – Discipline	50%	50%
ISC – Discipline	60%	40%
TCP – Discipline	50%	50%

Skill Allocations

As mentioned earlier, each Representative Task is tested at a specific Skill Level, and each part of the exam has its own weighting of the Skill Levels, as seen here.

Section	Remembering & Understanding	Application	Analysis	Evaluation
AUD – Core	30–40%	30–40%	15–25%	5–15%
FAR – Core	5–15%	45–55%	35–45%	–
REG – Core	25–35%	35–45%	25–35%	–
BAR – Discipline	10–20%	45–55%	30–40%	–
ISC – Discipline	55–65%	20–30%	10–20%	–
TCP – Discipline	5–15%	55–65%	25–35%	–

Content Allocations

The AICPA Blueprints address how coverage of the various content areas is allocated in each exam. Using the UWorld system that ties directly to the Blueprint structure, it is easy to see the extent to which each topic is covered.

AUD

Content Area		Allocation
Area I	Ethics, Professional Responsibilities, and General Principles	15–25%
Area II	Assessing Risk and Developing a Planned Response	25–35%
Area III	Performing Further Procedures and Obtaining Evidence	30–40%
Area IV	Forming Conclusions and Reporting	10–20%

FAR

Content Area		Allocation
Area I	Financial Reporting	30–40%
Area II	Select Balance Sheet Accounts	30–40%
Area III	Select Transactions	25–35%

REG

Content Area		Allocation
Area I	Ethics, Professional Responsibilities, and Federal Tax Procedures	10–20%
Area II	Business Law	15–25%
Area III	Federal Taxation of Property Transactions	5–15%
Area IV	Federal Taxation of Individuals	22–32%
Area V	Federal Taxation of Entities (including tax preparation)	23–33%

BAR

Content Area		Allocation
Area I	Business Analysis	40–50%
Area II	Technical Accounting and Reporting	35–45%
Area III	State and Local Governments	10–20%

ISC

Content Area		Allocation
Area I	Information Systems and Data Management	35–45%
Area II	Security, Confidentiality, and Privacy	35–45%
Area III	Considerations for System and Organization Controls (SOC) Engagements	15–25%

TCP

Content Area		Allocation
Area I	Tax Compliance and Planning for Individuals and Personal Financial Planning	30–40%
Area II	Entity Tax Compliance	30–40%
Area III	Entity Tax Planning	10–20%
Area IV	Property Transactions (disposition of assets)	10–20%

Exam Testlets

Each section of the exam is divided into five testlets. Two testlets cover MCQs and three testlets cover TBSs. Not all sections have an equal number of MCQs and TBSs, as the following chart shows.

Section	Testlet					Total	
	1 MCQ	2 MCQ	3 TBS	4 TBS	5 TBS	MCQ	TBS
AUD – Core	39	39	2	3	2	78	7
FAR – Core	25	25	2	3	2	50	7
REG – Core	36	36	2	3	3	72	8
BAR – Discipline	25	25	2	3	2	50	7
ISC – Discipline	41	41	1	3	2	82	6
TCP – Discipline	34	34	2	3	2	68	7

Finally, to manage your time effectively in the exam, we recommend that you:

- Use 75 seconds per multiple-choice question as a benchmark,
- Allocate 15–20 minutes per task-based simulation, depending on complexity, and
- Take the standard 15-minute break after the third testlet; it doesn't count against your time.

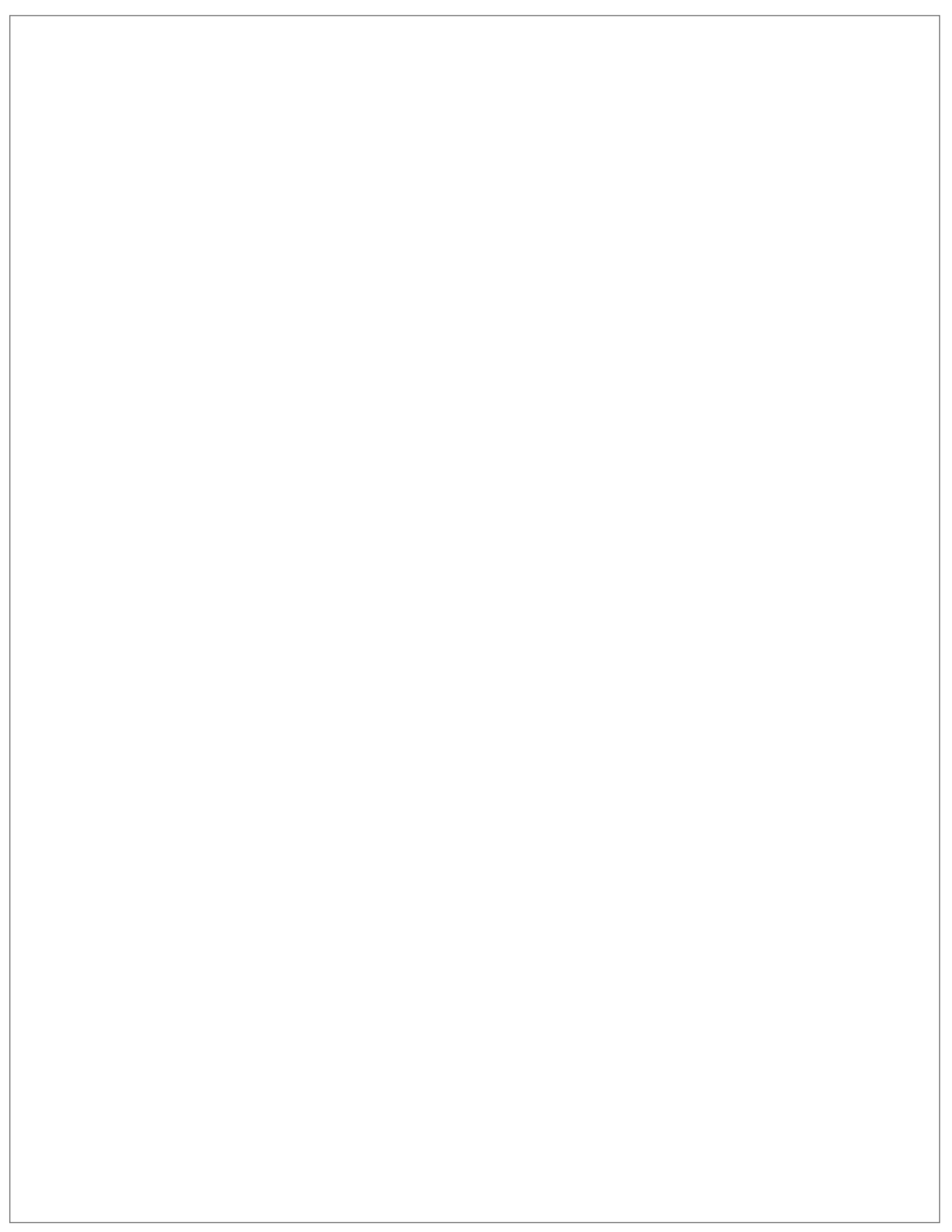
To see the full AICPA Blueprints, visit the AICPA website.

Above all, start the study process with confidence! As Roger always says, "You do not have to be a genius to pass the CPA Exam. If you study, you will pass!" You've got this.



TCP

**Area I: Tax Compliance and
Planning for Individuals and
Personal Financial Planning**





TCP 1
**Tax Compliance and
Planning for Individuals**

TCP 1: Tax Compliance and Planning for Individuals

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1.01 Tax Compliance and Planning for Individuals

Introduction

The Tax Compliance and Planning (TCP) section of the Uniform CPA Exam assesses a candidate's knowledge and skills with respect to U.S. federal tax compliance for individuals and entities (eg, partnerships, C and S corporations, trusts) for nonroutine and higher-complexity transactions involved with the preparation and review of tax returns. The candidate is expected to have an existing foundational core of knowledge regarding the taxation of individuals and business entities, which is tested in the Taxation and Regulation (REG) core section of the exam.

In addition, the tax-planning sections of TCP focus on planning strategies and opportunities to maximize the after-tax wealth of taxpayers while also considering the nontax costs and benefits. Candidates should be able to determine the tax implications of proposed transactions and available alternatives.

The first area of TCP focuses on tax compliance and planning for individuals and personal financial planning. The basics of most tax and personal financial planning involve developing strategies that ensure financial decisions are made that result in the taxpayer minimizing their tax liability while maximizing after-tax wealth. Considerations include the timing of income and deductions (sometimes referred to as the smoothing of income and bunching of deductions).

Areas of personal financial planning that are assessed on the exam include:

- Increasing after-tax income by making use of tax-deferred or tax-free income opportunities (eg, flexible spending accounts, qualified health savings accounts)
- Identifying the effect of changing tax rates and legislation on the timing of income and expense items
- Considering the impact of using either itemized deductions or the standard deduction for planning purposes
- Determining the potential tax savings when gifting or donating noncash property
- Understanding the risks associated with different investment options and how insurance is used to mitigate risk
- Planning for postsecondary education and personal retirement so tax benefits and cash outflows are maximized

Equity Compensation Awards

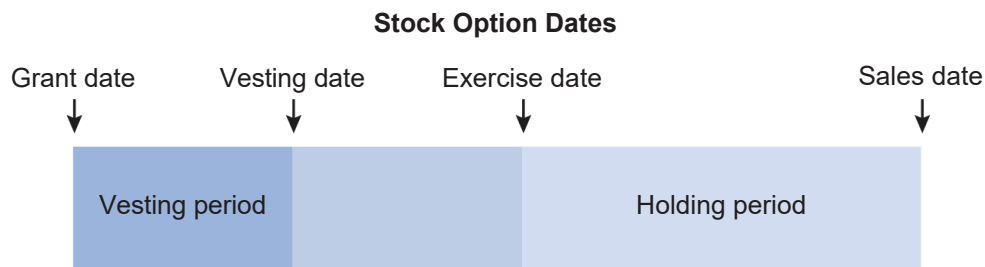


Representative Task (Remembering & Understanding): Recall the impact of equity compensation awards on taxable income.

Stock Options

Employers use equity compensation awards (ie, equity in the company) as part of a hiring offer to reward employees and encourage retention. Typical noncash equity compensation awards are incentive stock options (ISOs). A stock option grants a person the right to buy a company's stock at a specified price for a *finite period of time*.

Taxpayers holding incentive stock options generally hold the option and wait to exercise the option (ie, purchase the stock) until the *FMV of the stock exceeds the exercise price* (ie, a bargain purchase). ISOs expire, and if not exercised, the options are forfeited. A vesting period is generally required before the options can be exercised.



- The *grant date* is the date employees are initially allocated stock options
- The *vesting date* is the time when stock options granted can be exercised
- The *exercise date* is the date that employees purchase stock using their options
- The *exercise price* (or strike price) is the amount paid to the employer to acquire shares with stock options
- The bargain element is the difference between the fair market value of stock and the exercise price on the exercise date

There are two types of stock options: **qualified** and **nonqualified**. Qualified options are more favorable to employees because of the deferral of income and because gains are taxed at the more favorable capital gains rates.

Qualified stock options, commonly called incentive stock options (ISOs), are granted only to employees. For regular income tax purposes, ISOs are **not taxed** when received by the taxpayer (grant date) or when the taxpayer pays the exercise price (ie, strike price) to acquire the shares on the exercise date.

- However, on the exercise date, the *difference* between FMV and the exercise price is **included** as a *positive alternative minimum tax (AMT) tax adjustment* (ie, added to AMT income) for the calculation of AMT. This amount is treated as a *negative adjustment* to AMT when the stock is later sold
- The **sale of the stock** triggers a **taxable** event for regular income tax purposes. The difference between the sales price and exercise price is treated as a long-term capital gain taxed at preferential tax rates (ie, 0%, 15%, or 20%) if the holding period requirements are met
 - The holding period requirements are at *least two years from the grant date and one year after the exercise date*. It is important to meet these two requirements because if either of the holding requirements is *not met*, the sale is treated as a *nonqualifying stock option* (discussed below)
 - The favorable *long-term capital gain treatment* is only available on up to \$100,000 of ISOs per grant year; options exercised that exceed the \$100,000 are taxed as nonqualified stock options



An employee was granted an option on 6/1/YR4 to purchase 190 shares of company stock, at \$500 per share. On 8/31/YR5, the trading price of the stock reached \$600 per share, and the employee exercised the option. On 11/30/YR6, the stock was sold for \$790 a share. The employee has a marginal tax rate of 22% and has a capital gains tax rate of 15%. What are the tax implications on the grant date, exercise date, and sales date?

The sale meets the holding period requirement (ie, two years after grant date and held more than one year from exercise date). Therefore, the sale receives the preferential capital gain treatment.

Grant date: For regular income tax purposes, no taxable event occurred.

Exercise date: For regular income tax purposes, no taxable event occurred. However, for AMT purposes, on the exercise date, the employee has \$19,000 positive tax adjustment [(\$600 FMV – \$500 exercise price) × 190 shares] when computing AMT income.

Sales date: The sale is a taxable event and results in a long-term capital gain taxed at 15%, as shown below. By receiving the preferential tax treatment, the employee saved \$3,857 in taxes.

Sales proceeds (\$790 × 190 shares)	\$150,100
Less: Exercise price (basis) (\$500 × 190 shares)	(95,000)
Long-term capital gain	\$ 55,100
Taxed at 15% capital gains rate	\$ 8,265
Less: Taxed at 22% marginal rate	(12,122)
Tax savings due to preferential treatment	\$ (3,857)

In addition, the \$19,000 positive AMT tax adjustment reported in the year the stock was exercised is treated as a *negative* AMT tax preference item when computing AMT income in the year of sale.

Nonqualified stock options (NQSOs) may be granted to employees, consultants, or contractors working for the company. These options receive *no special tax treatment* and are generally reported on a W-2 or 1099 in the year exercised. The employer is required to withhold payroll taxes on the amount reported (ie, difference between FMV on date exercised and exercise price).

- Generally, for regular income tax purposes, there are no tax consequences for the taxpayer on the grant date or the vesting date assuming there is no readily available determined FMV for the options
 - If the stock has a *readily available value* (traded on a stock market), a NQSO *is taxable at the grant date* for the difference between the FMV and exercise price
 - Taxes paid on the NQSO are added to the basis of the options (if taxed at grant date) or stock (if taxed at exercise date)
- On the *exercise date*, the difference between the FMV and the exercise price is taxable as compensation (ordinary income). There are no holding period requirements for an NQSO and no AMT considerations
- On the *sale date*, the difference between the sales price and the FMV on the exercise date equals either a long-term or short-term capital gain or loss

ISO That Has a Disqualifying Disposition: When a taxpayer fails to meet the holding period requirement for an ISO, a disqualifying disposition results. The ISO is treated as an NQSO.

- The taxpayer has ordinary compensation income and a capital gain or loss
- The difference between the FMV and exercise price is taxed as compensation income (ordinary income)
- The difference between the FMV when exercised and the sales price is reported as long-term or short-term capital gain or loss depending on the holding period

Transaction	Incentive Stock Options (ISOs)	Nonqualified Stock Options (NQSOs)
Grant Date	<ul style="list-style-type: none"> • Not taxable for regular income tax • Not taxable for AMT 	Not taxable
Exercise Date	<ul style="list-style-type: none"> • Nontaxable for regular income tax • May trigger AMT liability (FMV of stock – Exercise price = Positive AMT adjustment) 	FMV of stock – Exercise price = Compensation (Ordinary income subject to income tax and payroll taxes)
Sales Date ≤ 1 Year	<ul style="list-style-type: none"> • Treated as NQSO • Compensation income = FMV of stock on exercise date – Exercise price • Short-term capital gain = Sales price – Exercise price 	Sales price – FMV of stock on exercise date = Short-term capital gain (loss)
Sales Date > 1 Year	<ul style="list-style-type: none"> • Long-term capital gain = Sales price – FMV of stock on exercise date • For AMT: Negative tax adjustment (FMV – Exercise price) 	Sales price – FMV on exercise date = Long-term capital gain (loss)

AMT = *alternative minimum tax*



An employee was granted an ISO on 7/1/YR1 to purchase 50 shares of company stock, at \$100 per share. There is no readily available determined FMV for the options on the grant date. On 5/1/YR2, the trading price of the stock reached \$125 per share, and the employee exercised the option. On 5/31/YR3, the employee sold the stock for \$130 per share. What are the regular income tax implications on the grant date, exercise date, and sales date? Ignore any AMT implications.

For regular income tax purposes, no taxable event occurred on the grant date or exercise date. When the stock was sold in Year 3, the stock was held for *more than one year* (5/1/YR2 through 5/31/YR3). However, the sale was *before* the required two years after the grant date (which would be 7/2/YR3).

Therefore, the holding period is not met, and the sale is treated as an NQSO. In Year 3, the employee reports a total gain of \$1,500 [(\$130 sales price × 50 shares) – (\$100 exercise price × 50 shares)] as \$1,250 compensation (ordinary income) and \$250 as long-term capital gain income, as computed below.

FMV on exercise date (\$125 × 50 shares)	\$6,250
Exercise price (basis) (\$100 × 50 shares)	(5,000)
Compensation income	\$1,250
Sales price (\$130 × 50 shares)	\$6,500
FMV on exercise date (\$125 × 50 shares)	(6,250)
Long-term capital gain	\$ 250



An independent contractor was granted an NQSO on 2/15/YR2 to purchase 1,000 shares of company stock, at \$200 per share. On 7/1/YR2, the trading price of the stock reached \$225 per share, and the contractor exercised the option. On 3/31/YR4, the contractor sold the stock for \$300 per share. What are the regular income tax implications on the grant date, exercise date, and sales date?

For regular income tax purposes, no taxable event occurred on the grant date. However, on the *exercise date*, the taxpayer reports compensation income of \$25,000.

FMV on exercise date ($\$225 \times 1,000$ shares)	\$225,000
Exercise price (basis) ($\$200 \times 1,000$ shares)	(200,000)
Compensation income	\$ 25,000

On the *sales date*, the contractor reports a long-term capital gain of \$75,000.

Sales price ($\$300 \times 1,000$ shares)	\$300,000
FMV on exercise date ($\$225 \times 1,000$ shares)	(225,000)
Long-term capital gain	\$ 75,000

Alternative Minimum Taxable Income



Representative Task (Remembering & Understanding): Recall items included in determination and computation of Alternative Minimum Taxable income.

Overview

The alternative minimum tax (AMT) was enacted to ensure that wealthy taxpayers do not circumvent paying taxes by taking advantage of certain tax deductions available to affluent taxpayers. AMT is based on **alternative minimum taxable income** (AMTI), which is the taxpayer's regular taxable income adjusted for certain income and deductions (ie, preferences and adjustments) that are treated differently for AMT purposes.

AMT preferences and certain adjustments that affect only *one tax year* cause a *permanent difference* between regular taxable income and AMTI. However, other adjustments (eg, incentive stock options) cause a difference in *more than one tax year* and are known as *temporary* (ie, timing) differences. A temporary difference reverses out in future years.

When allowed, a taxpayer may elect to treat certain income and deductions for regular tax purposes the way the items are treated for AMT. This would eliminate many of the tax-positive adjustments and reduce the possibility of incurring an AMT liability.

In addition, an AMT exemption (subject to a phaseout) is permitted to ensure taxpayers with minor preferences and adjustments do not incur an AMT liability. When the tentative minimum tax *exceeds* the regular tax liability, the *difference* equals the AMT tax that is owed.

AMT Formula	
Regular taxable income*	
+ Tax preferences	
± Adjustments	
<hr/>	
= AMTI	
- AMT exemption (\$137,000 MFJ, \$88,100 single and HOH for 2025)	
<hr/>	
= AMT base	
× AMT tax rate (26% or 28%)	
<hr/>	
= Tentative AMT (before foreign tax credit)	
- AMT foreign tax credit	
<hr/>	
= Tentative AMT	
- Regular income tax liability	
<hr/>	
= AMT	

*Must be increased by the standard deduction, if used.

AMT Tax Preferences

Tax preferences are always *positive* (ie, added) when computing AMTI. The preferences can involve income or a deduction. When the amount of a deduction for regular tax *exceeds* the amount allowed for AMT, generally the excess is added back. Likewise, income that is *not* taxable for regular tax but is taxable for AMT is added to increase the AMTI.

Examples of Tax Preferences

Added When Computing AMTI	
Interest Earned on Private Activity Bonds	Excluded from taxable income but added to compute AMTI
Excess Intangible Drill Costs	Deduction for regular tax is more than allowed for AMT, so excess is added back
Percentage Depletion	Excess of the regular tax deduction over the property's adjusted basis is added back
Gain on Small Business Stock	7% of the excluded gain is added back for stock acquired before 9/27/2010

AMT Tax Adjustments

Unlike tax preferences, *adjustments* may be *positive* (added) or *negative* (deducted) when determining AMTI. The direction of the adjustment depends on how the income or deduction is treated for regular tax purposes versus how it is computed for AMT.

If the adjustment is temporary (ie, a timing difference), it will reverse in future years. For example, when an incentive stock option is exercised, it is a nontaxable event for regular tax. However, for AMT purposes, a *positive* AMT adjustment is created for the excess of the FMV of the stock over the exercise price. When the stock is sold in the future, a taxable event has occurred for regular tax; however, for AMT purposes, part of the income has already been considered when the option was exercised. Therefore, a *negative* AMT adjustment results for the amount equal to the positive adjustment made on the exercise date.

Impact of Adjustments on AMTI

	Positive Adjustment	Negative Adjustment
Tax deduction > AMT deduction	✓	
Tax income < AMT income	✓	
Tax deduction < AMT deduction		✓
Tax income > AMT income		✓



No adjustment is required for AMT purposes if the amount of income or expense for regular tax purposes is the same amount allowed for AMT purposes. There are numerous AMT tax adjustments. Among those, depreciation is frequently tested.

Personal Property Depreciation: Most depreciation methods are the same for regular tax and AMT, as well as Section 179 and bonus depreciation. However, there is a difference for the depreciation deduction, where regular tax uses the 200% declining balance and AMT uses 150% declining balance for *personal property*.

The direction of the adjustments (positive or negative) depends on whether the depreciation *deduction allowed for regular tax is greater or less* than the amount allowed for AMT. This is an example of a timing difference. When the asset is fully depreciated, the *total* amount of depreciation taken is the same for regular tax and AMT. The difference is the dollar amount taken each year over the asset's life.



A taxpayer purchased a depreciable asset for \$10,000 with a five-year life and no salvage value. Below is a table comparing the depreciation deduction allowed for regular tax purposes (ie, 200% declining balance-half-year convention) and for AMT (ie, 150% declining balance-half-year convention).

Notice that in the early years, the difference in depreciation allowed creates a *positive* AMT because the tax deduction *exceeds* the deduction permitted for AMT. In the latter years, the reverse occurs, creating a negative adjustment. Over the life of the asset, the total depreciation is the same.

	Regular Tax Depreciation	AMT Depreciation	AMT Adjustment	
			Amount	Type
Year 1	\$ 2,000	\$ 1,500	\$500	Positive (Tax > AMT)
Year 2	3,200	2,550	650	Positive (Tax > AMT)
Year 3	1,920	1,785	135	Positive (Tax > AMT)
Year 4	1,152	1,666	(514)	Negative (Tax < AMT)
Year 5	1,152	1,666	(514)	Negative (Tax < AMT)
Year 6	576	833	(257)	Negative (Tax < AMT)
Total	\$10,000	\$10,000	\$ 0	

Examples of AMT Adjustments*	
Personal Depreciable Property	<ul style="list-style-type: none"> • Regular tax uses 200% declining balance • AMT uses 150% declining balance
Incentive Stock Options	<ul style="list-style-type: none"> • For regular tax, on exercise date, no taxable income • For AMT, on exercise date, the bargain element (FMV of stock – Exercise price) is taxable
Certain Itemized Deductions	<ul style="list-style-type: none"> • State income or sales taxes: Positive adjustment (up to the \$10,000 max allowed) • Interest: Limited to qualified <i>housing</i> interest versus the qualified <i>residence</i> interest allowed for regular tax • Net investment interest: Limited to net investment income for both regular tax and AMT; however, for AMT, compute using any tax preferences or adjustments rules (ie, include interest from private activity bonds)
Local and State Income Tax Refunds	<ul style="list-style-type: none"> • If included in taxable income, excluded from AMT
Completed Contract Method	<ul style="list-style-type: none"> • For regular tax, the completed contract may be used if certain criteria are met • For AMT, the percentage of completion <i>must</i> be used
Pollution Control Facilities	<ul style="list-style-type: none"> • For regular tax purposes, an election can be made to amortize the cost over five years • For AMT, the straight-line method is used over the asset's normal depreciable life
Circulation Expenditures	<ul style="list-style-type: none"> • For regular tax purposes, an election to expense when incurred • For AMT, amortized over three years
Alternative Tax NOL Deduction (ATNOLD)	<ul style="list-style-type: none"> • For AMT purposes, an NOL must be adjusted for tax preferences and tax adjustments
Mine Exploration and Development Costs	<ul style="list-style-type: none"> • For regular tax purposes, an election to expense when incurred
Research and Experimental Costs	<ul style="list-style-type: none"> • For AMT, amortized over 10 years

**If a taxpayer uses the standard deduction, the amount is added to taxable income (the starting point for AMT) and not treated as separate adjustment.*

Other Considerations Regarding AMT Tax Adjustments

Since the amount of a deduction may be different for regular tax than for AMT purposes, it would stand to reason that the deductions could impact the computation of a gain or loss on the sale of a depreciable asset. However, if a depreciable asset is fully depreciated, the gain or loss will be the same since the carrying values for regular tax and AMT would be identical.



A taxpayer sells equipment for \$20,000. The cost of the equipment was \$60,000, and accumulated depreciation for regular tax was \$35,000 and \$28,000 for AMT. The loss on the sale will be *different* for regular tax purposes and AMT due to different carrying values.

	<u>Regular Tax</u>	<u>AMT</u>
Equipment cost	\$60,000	\$ 60,000
Less: Accumulated depreciation	<u>(35,000)</u>	<u>(28,000)</u>
Carrying value	\$25,000	\$ 32,000
Sales price	<u>(20,000)</u>	<u>(20,000)</u>
Loss on sale	\$ (5,000)	\$(12,000)

Because depreciation is a timing difference, the recognized loss for regular tax is *less* than for AMT because a larger amount of depreciation deductions had been taken at the time of the sale. However, the *total deductions* for the equipment equal the same amount for both regular tax and AMT. The total is \$40,000 (\$35,000 depreciation + \$5,000 loss) for regular tax and \$40,000 (\$28,000 depreciation + \$12,000 loss) for AMT.

Summary

Below is a summary of the *most frequently tested* tax preferences and adjustments. The mnemonic "**PLIER**" can help with remembering the items. Remember that the standard deduction, if used by the taxpayer, is always added to the taxable income as the starting point for computing AMTI.

AMT Preferences and Adjustments (PLIER)	
Type	Examples
Tax preferences (always add)	+ P Private activity bond interest earned
	+ L Local and state income taxes (or general sales tax), property taxes
Tax adjustments (add or deduct)	+ I Incentive stock options when exercised (FMV of stock – Exercise price)*
	± E Excess depreciation on personal property
	– R Refunds of state and local taxes included in taxable income

*Creates offsetting negative tax adjustment when the stock acquired is sold.



A review of a taxpayer's income and expenses from the current year included the following items:

Interest income from private activity bonds	\$ 5,000
Taxable state income tax refund	1,200
Personal property depreciation for regular tax	8,500
Personal property depreciation for AMT	6,000
Local and state income taxes	12,000
Charitable contributions	15,000

The taxpayer itemizes deductions instead of using the standard deduction. In addition, the taxpayer exercised 1,000 incentive stock options when the per share FMV of the stock was \$50 and the exercise price was \$35. The taxpayer's taxable income is \$180,000. What amount is the taxpayer's AMTI?

Remember the mnemonic PLIER. The starting point for AMTI is taxable income adjusted for the standard deduction, if used. Here, the taxpayer itemized deductions, so no beginning adjustment to taxable income is needed. However, other items will impact the computation of AMTI, as shown below.

- The \$5,000 interest earned from the private activity bonds is a tax preference item that is added
- For regular tax purposes, the local and state income tax deduction is limited to \$10,000. Therefore, that is the maximum that can be added back when determining AMTI
- The exercise of the stock options is nontaxable for regular tax, but for AMT, the difference between the FMV of the stock and the amount exercised is a positive tax adjustment. A \$15,000 $[(\$50 \text{ FMV} - \$35 \text{ exercise price}) \times 1,000 \text{ options}]$ positive adjustment is required
- The \$2,500 ($\$8,500 \text{ tax depreciation} - \$6,000 \text{ AMT depreciation}$) excess tax depreciation for the personal property is a positive tax adjustment
- The taxable state income tax refund is a negative adjustment for AMTI
- The charitable contributions deduction has no adjustment for AMTI

Taxable income	\$180,000
Tax preference	
+ Private activity bond interest earned	5,000
Tax adjustments	
+ Local and state income taxes (limited to \$10,000)	10,000
+ Incentive stock options	15,000
+ Excess tax depreciation	2,500
– Refund of taxable state income tax	(1,200)
AMTI	\$211,300

Imputed Interest on Below-Market Rate Loans and Foreign Earned Compensation



Representative Task (Application): Consider the impact to an individual's taxable income for certain items of gross income, including imputed interest on below-market rate loans and compensation earned while employed outside the U.S.

Imputed Interest Rules

Loans made at arm's length bear a reasonable amount of interest to be paid by the borrower. However, loans made between related parties (eg, family members, a partner, and a partnership) often charge little or no interest. Generally, this is because the loan really may not be a loan to the borrower (eg, a disguised gift, dividend, compensation) or the lender is trying to avoid taxable interest income or the borrower is attempting to underreport their debt liability.

When a taxpayer makes a below-market interest or a no interest loan, the tax code requires that interest must be *imputed*. Imputed interest refers to the interest that the lender *should* have charged and the borrower should have paid.

- Specifically, any *no interest loans or loans with an interest rate below the Applicable Federal Rate (AFR)* (referred to as below-market loans) require imputed interest. This means that interest is computed for what should have been paid even if there were no actual interest payments made by the borrower
- The AFR is the *minimum loan* interest rate set by the IRS each month. The rate may vary due to the length of the debt obligation (eg, short term, midterm, long term), and the interest can be compounded annually, semiannually, quarterly, or monthly
- The formula for imputing interest is the standard interest formula with the *exception* that AFR is used as the interest rate

$$\text{Loan principal} \times \text{AFR \%} \times \text{Time} = \text{Imputed interest}$$

Forgone Interest

Although *below-market interest loans* bear interest, the rate is below the AFR. Therefore, the imputed interest equals the **forgone interest**, which is the excess amount of interest computed at the AFR over any interest actually paid or accrued.

$$\text{Interest computed using the AFR \%} - \text{Interest actually paid} = \text{Forgone interest}$$



A C corporation lends a shareholder \$200,000 on March 1, Year 1, at a 1% interest rate, compounded annually. The AFR is 2.5%.

The interest paid in Year 1 is \$1,667 ($\$200,000 \times 1\% \times 10/12$). However, the *imputed interest* using the AFR is \$4,167 ($\$200,000 \times 2.5\% \times 10/12$). Therefore, the *forgone interest* equals \$2,500 ($\$4,167 - \$1,667$).

If *no interest* was charged on the loan, the imputed and forgone interest would both be \$4,167 ($\$4,167$ imputed interest – \$0 interest paid).

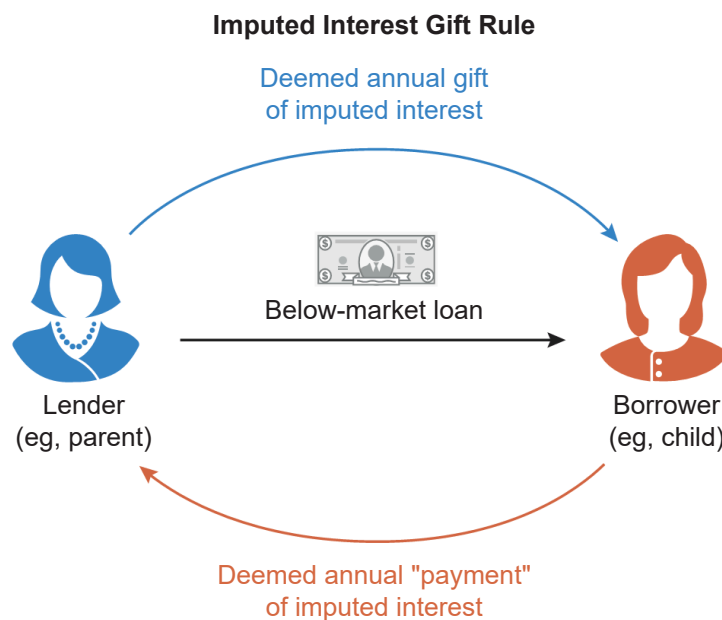
Tax Consequences of Imputed Interest

The types of loans affected by the imputed interest rules are below-market loans, demand loans, and gift loans. The imputed interest (if no interest is charged) or the forgone interest (if some interest is charged) is treated as a gift, dividend, contribution to capital, payment of compensation, or other payment, from the lender to the borrower, depending on the underlying substance of the loan.

The most common below-market loans subject to the imputed interest rules are:

- Gift loans between family members,
- Compensation-related loans between an employer and employee, and
- Loans between a corporation and a shareholder.

Gift loans are generally interest-free between family members who treat the *forgone interest as a gift* from the lender (eg, parent) to the borrower (eg, child). Then, the borrower theoretically *retransfers* the forgone interest back to the lender, who treats it as *interest income*. The transfer of the forgone interest is deemed to occur on the last day of the calendar year. Therefore, the lender may owe gift tax on the amount of forgone interest each year the loan is outstanding.



On July 1, Year 3, a parent lends her daughter \$50,000 and charges no interest rate. The AFR for Year 3 is 4%. What are the tax consequences for the parent and the child?

The forgone interest is \$1,000, as computed below.

Imputed interest ($\$50,000 \times 4\% \times 6/12$)	\$1,000
Less: Actual interest	(0)
Forgone interest	\$1,000

The parent has made a \$1,000 gift to the child. The parent has \$1,000 of reportable interest income. There are no tax consequences to the child.