Tax Educators’ Network, Inc.
and
ACE Seminars

2023 Federal Income Tax Update

Comprehensive Manual
for
Business Entities
and
Individual Clients

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As an accounting graduate of La Salle University in Philadelphia, Prof. Connors went on for his law degree at the University of Notre Dame, graduating in 1980. After serving as an instructor in the School of Business Administration, he obtained his Masters of Law in Taxation at the University of Miami Law School in Coral Gables, Florida. He then served on the graduate tax faculty at the University of Wisconsin's School of Business in Milwaukee, WI.

His professional background includes over 50 years of experience in income and estate tax planning, as well as individual, partnership and corporate tax return preparation and research as a senior tax consultant for Price Waterhouse in the Philadelphia and South Bend offices. Prof. Connors also worked on expatriate and corporate tax matters as an international tax consultant for the Chrysler Corporation in London, England.

Prof. Connors currently conducts a national consulting practice designed especially for tax professionals based out of Milwaukee, WI. He also publishes a tax newsletter devoted exclusively to practitioners over the last 30 years entitled the ***Monthly Tax Update***. He has been the outside editor for **CCH's Federal Tax Course**, and has spoken at numerous tax institutes, workshops and conferences around the country. And, his **"Complete Guide to Depreciation, Amortization & Transfers of Property - Issues, Strategies & Answers"** is sold to tax practitioners throughout the U.S., along with annual tax guides entitled **"LLCs Taxed as Partnerships," "Taxation of Real Estate Investments,"** and **"Choice of Entity."**

As a nationally known speaker on a variety of tax topics, Prof. Connors has consistently earned average overall ratings in excess of 4.7 (i.e., on a 5.0 scale) for his knowledge and presentation skills, as well as the quality of his materials. In 2013, he was selected to receive the **AICPA Sidney Kess Award for Excellence in Continuing Education**. And, on any item that he has presented in his materials, he is available for follow-up questions, a factor much-appreciated by those practitioners attending his seminars over the last 45 years.

Tax Update - Workshop Objectives/Comments

1. Comprehensive review of recent tax developments impacting preparation of 2023 returns

   - Includes older tax developments still valid for 2023 tax year return preparation

   - Will include numerous examples and editorial comments

2. Reminder of key considerations when inputting information for tax prep software

   - Inputting source information where thresholds/caps vary (e.g., home energy credits)

3. Review of key consulting issues that arise every busy season

   - Preparing Sec. 754 election and calculating step-up amount

4. Critical to readily spot potential tax issues & efficiently deal with them

   - Google searches have been extremely effective

   - Tax prep is <u>not</u> just blindly inputting W-2s, 1099s and K-1s

5. One comprehensive tax update manual

   - "Light blue" highlights for Individual Clients

   - "Yellow" highlights for Business Clients

6. Highlights eliminate need to go back and forth from PPT slides to text

   - Client comments/annotations can be made directly in manual

7. Where applicable, emphasis on possible yearend planning strategies for clients

   - Interview key clients for potential tax moves coming about in near future

   - Best to get "beneficial ownership" information when preparing 2023 returns

2023 Federal Income Tax Update

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I. NEW TAX DEVELOPMENTS - ARRANGED BY CODE SECTION & CATEGORY

GENERAL LEGISLATIVE MATTERS:

Miscellaneous:

☞**Inflation Reduction Act (H.R. 5376)**

The **Inflation Reduction Act** which was signed into law by Pres. Biden on 8/16/2022 represents $430 billion in spending which addresses climate and health care issues, as well as containing a number of new tax provisions. For example, the Health Secretary will now be authorized to negotiate prices for prescription drugs for Medicare, while extending the **Affordable Care Act** health care benefits for three years through 2025.

> **Comment:** The law adds **Code §5000D** which imposes a *new* excise tax on sales by drug manufacturers, producers, and importers of "designated drugs" during the time that the manufacturer, etc., fails to enter into drug pricing agreements under the **Social Security Act** (i.e., with regard to Medicare as mentioned above).

> **Comment:** As far as the various business energy credits, companies will be able to "monetize" ten of the clean energy credits which essentially equates to receiving tax-free money. For tax years that begin *after* 2022, businesses may elect to transfer certain credits to unrelated third parties for cash and then exclude the proceeds from gross income.

> **Comment:** One of key items omitted from the **Inflation Reduction Act** concerns the regulation of unenrolled preparers (i.e., those tax return preparers who are *not* CPAs, attorneys or enrolled agents). Although President Biden, the IRS, tax practitioner groups and others wanted tax preparer oversight, it was opposed by powerful free-market groups and ultimately did *not* have the support in Congress.

As far as the new tax provisions, here is a brief overview:

- Extends the "excess business loss limitations" (EBL) under **Code §461(l)** for *non-corporate* taxpayers for two more years through 2028.

> **Comment:** After applying the first three restrictions for taking a K-1 loss (i.e., basis, **Form 6198** at-risk limitation, and **Code §469** passive loss rules), **Code §461(l)** (which was delayed from 1/1/2018 until the 2021 tax year) comes into play as a "fourth restriction." Essentially, an "excess business loss" is defined (for the 2023 tax year) as an otherwise allowable loss which is $289,000 ($578,000 for MFJ filers) or more in excess of the taxpayer's "business income" (which the IRS has stated does *not* include wages). And, any such "excess" is treated as an NOL carryover to future tax years.

> **Comment:** This provision is expected to raise $53.8 billion in revenue through additional taxes over 10 years.

- Increases the research credit that can be used to offset payroll taxes (i.e., as opposed to just income taxes) for "qualified small businesses" (i.e., for 2023, those businesses with average gross receipts of $29 million or less) from $250,000 to $500,000 for tax years beginning *after* 2022.

> **Comment:** The **TCJA** requires that beginning in 2022, research and development costs must be

capitalized and amortized over 5 years (i.e., instead of being immediately deductible as a credit). Although changes to the capitalization rule have been proposed, none of those proposals have been enacted at this time (i.e., as part of the **Inflation Reduction Act**). As a result, capitalization of such costs will be required with a 60-month amortization period.

- Extends the **Code §25C** nonbusiness (i.e., residential) energy property credit (which expired at the end of 2021) for 11 years through 2032, modifies the credit for expenditures *after* 2021 to be 30% (instead of the current 10% which will still be in effect for the 2022 tax year), and replaces the current $500 lifetime credit with a $1,200 annual maximum credit (also starting with the 2023 tax year but with no lifetime cap). There are certain limitations, such as $600 for exterior windows and skylights, $250 for exterior doors (annual maximum of $500 for all exterior doors) and $2,000 for heat pumps, heat pump water heaters, and biomass stoves and boilers (i.e., this $2,000 is a separate, annual cap on such items).

Comment: Moreover, the definition of "eligible property" for purposes of this credit is now expanded to include residential property that is *not* the taxpayer's primary residence (e.g., vacation or second homes).

Comment: For 2023 and beyond, the credit is renamed the **"Energy Efficient Home Improvement Credit."** The credit further increases, in an amount up to $150, for amounts paid for a "home energy audit." Also, beginning in 2025, taxpayers will be required to have a "qualified product identification number" from a "qualified manufacturer" to take the credit.

Comment: As a tax credit for "improvements," it only applies to homes that the taxpayer already owns (i.e., *not* to newly-constructed homes).

Comment: This provision is estimated to cost $12 billion.

☞**IRS Provides Detailed Additional Guidance on Home Energy Tax Credits**

Taxpayers making energy improvements to their home have several tax credits available for a portion of qualifying expenses. The credit amounts and types of qualifying expenses were expanded by the **Inflation Reduction Act of 2022**. Eligibility for either the **Code §25C** **Energy Efficient Home Improvement Credit** or the **Code §25D** **Residential Energy Clean Property Credit** is determined for the year when the qualifying improvements are actually completed. Homeowners who improve their *primary* residence will find the most opportunities to claim a credit for qualifying expenses. However, renters may also be able to claim credits, as well as owners of *second* homes used as residences.

Comment: These credits are never available for improvements made to homes that the taxpayer does *not* use as a residence (i.e., the premises are used strictly as a rental property or completely for business purposes). But if less than 100% of the residence was used for either rental or business purposes, a full credit would still be allowed so long as the premises are *not* used for such purposes exceeding 20%. On the other hand, if these ineligible uses do in fact exceed 20%, only a pro rata portion of the credit will be allowed. More details can be found on the IRS **Energy Efficient Home Improvement Credit** **website**. The Service has also set up a special **website** that deals with frequently-asked questions (FAQs).

Comment: If a taxpayer is renting a home as their *principal* residence and makes eligible improvements, a tax credit may be available to the tenant.

Energy Efficient Home Improvement Credit: Under **Code §25C** the following expenses may qualify for up to a 30% tax credit if they otherwise meet requirements detailed on **energy.gov** but would include:

- Exterior doors, windows, skylights and insulation materials
- Central air conditioners, water heaters, furnaces, boilers and heat pumps
- Biomass stoves and boilers
- Home energy audits

Comment: To qualify, home improvements must meet energy efficiency standards. They must also be *new* systems and materials, *not used*.

There are limits on the allowable *annual* credit and on the amount of credit for certain types of qualified expenses as follows:

- $1,200 maximum *annual* credit for energy property costs and certain energy efficient home improvements, with limits on doors ($250 per door and $500 total), windows ($600) and home energy audits ($150)

- $2,000 per year for qualified heat pumps, biomass stoves or biomass boilers

Comment: So if a taxpayer makes qualified energy-efficient improvements to their home *after* Jan. 1, 2023, they may qualify for a annual tax credit up to $3,200 (i.e., $1,200 + $2,000) through the 2032 tax year.

Credit Calculation: The amount of the credit allowed is a percentage of the total improvement expenses in the year of installation as follows:

- 2022: 30%, up to a *lifetime* maximum of $500

- 2023 through 2032: 30%, up to an *annual* maximum of $1,200 (biomass stoves and boilers have a separate annual credit limit of $2,000), with no lifetime limit

Comment: As mentioned above, this nonrefundable credit has *no lifetime dollar limit*. As a result, taxpayers can claim the maximum annual credit every year that you make eligible improvements until 2033. In addition, taxpayers can *carry forward* any excess unused credit and apply it to reduce taxes owe in future years.

Qualifying Taxpayers: Taxpayers may claim the energy efficient home improvement credit for improvements to their *principal* residence. However, the home must be (1) Located in the United States and (2) An *existing* home that is being improved or add onto, *not* a new home.

Comment: Although qualifying energy improvements cannot be made as a *new* home is built, there is no "time limit" mentioned in the law as to how soon after occupying the new home that work on these improvements can commence.

Subsidies, Rebates & Incentives: When calculating the credit, taxpayers may need to subtract subsidies, rebates, or other financial incentives from their qualified property expenses because they need to be treated as a "purchase price adjustment."

Form 5695: Taxpayers will file **Form 5695, Residential Energy Credits Part II**, with their tax return to claim the credit. Furthermore, taxpayers are required to claim the credit for the tax year when the energy related property is actually installed, *not* merely purchased.

Residential Clean Energy Property Credit: Under **Code §25D**, these expenses may also qualify for a tax credit if they meet requirements detailed on **energy.gov**:

- Solar, wind and geothermal power generation
- Solar water heaters
- Fuel cells
- Battery storage (beginning in 2023)

Comment: Fuel cell property is limited to $500 for each half kilowatt of capacity. If more than one person lives in the home, the combined credit for all residents cannot exceed $1,667 for each half kilowatt of fuel cell capacity.

Comment: As is the case with **Energy Efficient Home Improvement Credit**, the **Residential Energy Clean Property Credit** is only available for *new* energy efficient property (i.e., even if meeting the definition of energy related property as listed above, *used* property does *not* qualify).

Other Related Costs: Qualified expenses may include labor costs for on-site preparation, assembly or original installation of the property and for piping or wiring to connect it to the home. On the other hand, traditional building components that primarily serve a roofing or structural function generally do *not* qualify. For example, roof trusses and traditional shingles that support solar panels do *not* qualify, but solar roofing tiles and solar shingles do because they generate clean energy.

Subsidies, Rebates & Incentives: As is the case with the **Energy Efficient Home Improvement Credit**, when calculating the **Residential Energy Clean Property Credit** , taxpayers may need to subtract subsidies, rebates, or other financial incentives from their qualified property expenses because they also need to be treated as a "purchase price adjustment."

Qualified Clean Energy Property: Clean energy property must meet the following standards to qualify for the residential clean energy credit:

- Solar water heaters must be certified by the **Solar Rating Certification Corporation** or a comparable entity endorsed by the taxpayer's state.

- Geothermal heat pumps must meet **Energy Star requirements** in effect at the time of purchase.

- Battery storage technology must have a capacity of at least 3 kilowatt hours.

Credit Calculation: The amount of the credit allowed is a percentage of the total improvement expenses in the year of installation as follows:

- 2022 to 2032: 30%, no annual maximum or lifetime limit

- 2033: 26%, no annual maximum or lifetime limit

-2034: 22%, no annual maximum or lifetime limit

Comment: Unlike the **Energy Efficient Home Improvement Credit**, the **Residential Clean Energy Property Credit** can be claimed for qualifying expenditures incurred for *either* an existing home or a newly-constructed home as long as it is located in the U.S. This applies to the taxpayer's principal residence, as well as second homes (although pro rata limitations may apply if either of these homes is *more than 20%* used for business or rental purposes).

Form 5695: Taxpayers will file **Form 5695, Residential Energy Credits Part I**, with their tax return to claim the credit. Furthermore, taxpayers are required to claim the credit for the tax year when the energy related property is actually installed, *not* merely purchased. **(Code §25C & 25D; Energy Tax Credits)**

☞**Home Energy Audits and Energy Efficient Home Improvement Credit (Notice 2023-59)**

The IRS has now issued the requirements needing to be met for "home energy audits" for taxpayers that want to claim the energy efficient home improvement credit. The **Inflation Reduction Act of 2022** created several clean energy credits. Each of these credits contains requirements which must be met for the specific type of clean energy property or service purchased and how they are to be claimed. This includes a *nonrefundable* "energy efficient home improvement credit" for the purchase and installation of certain energy efficient improvements in a taxpayer's principal residence (i.e., improving a home that is already occupied, and *not* a newly-constructed one).

The credit amount is equal to 30% of the total amount that taxpayers pay during the year for:

- Qualified energy efficiency improvements installed during the year;

- Residential energy property expenditures; and

- Home energy audits

This recent IRS guidance includes the detailed requirements to claim the home energy improvement credit and the process for conducting the home energy audit. The audit must "identify the most significant and cost-effective energy efficiency improvements to the residence, including an estimate of the energy and cost savings to each improvement." The maximum credit for home energy audits is $150. As a result, taxpayers can claim a 30% credit on audits that cost up to $500. In addition, the home energy auditor must provide a *written* audit report to the taxpayer.

When obtaining a residential energy audit taxpayers need to make sure that it meets the credit requirements. Specifically, taxpayers will need to substantiate that a "qualified auditor" conducted their home audit. To satisfy this requirement, the written audit should state that the auditor is certified to conduct the home energy audit.

The home energy efficient home improvement is a *nonrefundable* credit, meaning that it can only reduce the amount of tax owed and will *not* create a refund. Furthermore, there is no carryover of an unused credit. **(Code §25C; Home Energy Audits)**

Comment: For more information on these credits and other clean energy credits related to the **Inflation Reduction Act** refer to the inflation reduction act credits and deductions page on IRS **website**.

- Extends and expands the **Code §25D** residential energy efficient property (REEP) credit, which is renamed the **"Residential Clean Energy Credit."** The credit was supposed to drop to 26 percent for 2022 and 22 percent for 2023. Then, the credit was scheduled to expire at the end of 2023. The credit which is available to taxpayers who install solar electric, solar hot water, fuel cell, small wind energy, geothermal heat pump, and biomass fuel property in their homes Is now available through 2034. The Act also expands the credit to include qualified battery storage technology expenditures beginning in 2023. The applicable credit rates are as follows:

1) 26% for property placed in service before Jan. 1, 2022;
2) 30% for property placed in service after Dec. 31, 2021, and before Jan. 1, 2033;
3) 26% for property placed in service after Dec. 31, 2032, and before Jan. 1, 2034; and
4) 22% for property placed in service after Dec. 31, 2033, and before Jan. 1, 2035

- Extends and enhances "production tax credits" under **Code §45** for electricity produced from "certain renewable resources," including facilities producing electricity from wind, geothermal, and solar. These credits expired at the end of 2021, but will now generally apply to projects placed into service for three additional years (i.e., *before* January 1, 2025).

Comment: This credit extension is estimated to cost $51 billion over 10 years.

- Increases the energy efficient commercial buildings deduction under **Code §179D**, beginning in 2023, but only for those contractors who meet the "prevailing wage requirements." Tax benefits range from $1 per square foot for all taxpayers to $5 per square foot for those who meet the "wage and apprenticeship requirements."

Comment: Keep in mind that the former version of the **Code §179D** credit was $.80/square foot for three distinct aspects of the structure (i.e., building envelope regarding installation, etc., HVAC and lighting which continue to be the three key elements with regard to the building credit).

Comment: This provision is estimated to cost $362 million over 10 years.

- Provides credits expected to cost $14 billion over 10 years to incentivize the use of "clean" vehicles. This part of the **Inflation Reduction Act** *overhauls* the qualified plug-in electric vehicle credit, while enacting two entirely *new* credits. The changes are generally effective for vehicles purchased or placed into service in 2023, although a few provisions are effective *before* that:

1) **Clean Vehicle Tax Credit:** This credit is an overhaul (including renaming) of the **Code § 30D** credit for *new* "qualified plug-in electric drive motor vehicles." Under the new provision, the maximum credit for qualifying vehicles is $7,500, beginning in 2023 through 2032. But, the credit availability will now instead depend upon the "sourcing of the battery and critical mineral components" (which begins when regulations are promulgated) and upon whether the *final* vehicle was assembled in North America (which begins on the 8/16/2022 date of enactment), although there is a safe harbor for those purchasing between January 1, 2022, and August 16, 2022). The Act *eliminates* the "200,000 EV per-manufacturer cap" on these credits. Perhaps most importantly, the Act also imposes "income limits" for eligibility of this credit ($300,000 MAGI for taxpayers filing joint returns or surviving spouses, $225,000 for heads of household, or $150,000 for other taxpayers). However, there is no phaseout (i.e., these are "cliff provision" thresholds), but the MAGI rules allow qualification based on the taxpayer's income in the *current or prior tax year*. The Act also imposes per vehicle price limits. If the manufacturer's suggested retail price exceeds these prices, there is no credit as follows: Vans, SUVs, Pickup Trucks ($80,000), Other vehicles ($55,000). Finally, beginning in 2024, otherwise available credits may instead be transferred to dealers.

Comment: To claim the credit, (1) original use of the clean vehicle must commence with the taxpayer, (2) the taxpayer cannot acquire the clean vehicle for resale, (3) the clean vehicle must be made by a "qualified manufacturer," and (4) the *final* assembly of the clean vehicle must occur in North America. And, as mentioned above, starting in 2023 it will *not* matter if manufacturers such as Tesla had already exceeded the 200,000-electric vehicle cap previously, so long as they are otherwise meeting the requirements listed above.

Comment: Because some models are built in multiple locations, there may be vehicles on the Department of Energy list that do *not* meet the "final assembly requirement." To identify the manufacture location for a specific vehicle, taxpayers should search the **Vehicle Identification Number (VIN)** of the vehicle. For vehicles purchased *after* 12/31/21 and *before* 8/16/22 but *not* yet delivered, the taxpayer may claim the credit based on the rules in effect *before* 8/16/22. If a qualifying EV is purchased and placed in service *after* 8/16/22 and *before* 1/1/23, aside from the "final assembly requirement," the rules in effect *before* the enactment of the **Inflation Reduction Act** for the EV credit apply (including those involving the 200,000-vehicle manufacturing cap on vehicles sold).

Comment: Treasury has released **FAQs** with initial information and guidance. Also, the following **website** lists all of the vehicles that would be eligible for the $7,500 credit.

2) **New Credit for Previously-owned Clean Vehicles:** Under **Code §25E**, this credit is $4,000 or 30 percent of the cost of the vehicle, whichever is *less*. The sales price cannot exceed $25,000, and MAGI limits are much lower: $150,000 for MFJ, $112,500 for HOH, and $75,000 for single filers. Finally, the credit can only be used once every three years for clean vehicles sold for $25,000 or less.

Comment: The IRS has also put out a new **video** on the reduced $4,000 tax credit for "used clean vehicles" causing $25,000 or less.

3) **New Credit for "Qualified Commercial Clean Vehicles:"** This new credit which can up to 30% of the cost of the vehicle will be pursuant to **Code §45W** acquired after 2022 and through 2032.

Comment: This still remains a loophole for more expensive vehicles which are otherwise leased with the dealer receiving the credit (with no income limitations or phaseout). And, of course, the dealer can factor this credit into the lease terms.

4) Extension and modification of alternative fuel vehicle refueling property credit through 2032 under **Code §30C**, but only in "rural census tracts or low-income census tracts."

Comment: There is one other significant change which begins in 2024. Again, it is the option for the buyer to "monetize the credit" by transferring it to the dealer at the time of purchase. The result is that the purchase price that the buyer pays for the car is correspondingly reduced. In other words, buyers would be able to take immediate advantage of the tax credit instead of waiting for the next year, when they actually file their tax returns.

Comment: This might be a yearend planning tip worth considering by delaying the purchase until the beginning of 2024?

☞**IRS Guidance on Claiming Clean Vehicle Tax Credits** (**Tax Tip 2023-49**)

The **Inflation Reduction Act of 2022** made several changes to the tax credits provided for qualified plug-in electric drive motor vehicles, including adding fuel cell vehicles to the tax credit. Beginning January 1, 2023, eligible vehicles may qualify for a tax credit of up to $7,500. The amount of the credit depends on when the eligible *new* clean vehicle is placed in service and whether the vehicle meets certain requirements for a full or partial credit as follows:

- The buyer must meet certain **income limitations**

  Comment: The taxpayer's modified AGI may *not* exceed: (1) $300,000 for married couples filing jointly; (2) $225,000 for heads of households; and (3) $150,000 for all other filers. It should also be noted that this is a "cliff threshold" and *not* a gradual phaseout mechanism which means if the taxpayer's modified AGI is even $1.00 over, no partial credit would be allowed.

- The **final assembly** of a new clean vehicle must occur within North America

- The vehicle cannot exceed a manufacturer suggested retail price of:

  (1)$80,000 for vans, sport utility vehicles and pickup trucks $55,000 for other vehicles

- The purchase of a new clean vehicle between **2009 and 2022** may also qualify for a tax credit.

The IRA also added a credit for ***used* clean vehicles**, which can equal 30% percent of the sale price up to a maximum credit of $4,000. However, this recent credit does *not* apply to used clean vehicles purchased *before* 2023.

The IRS has provided an updated list of frequently asked questions (**FAQs**) about new and used clean vehicle credits that covers:

- Eligibility rules;

- Income and price limitations;

- When the new requirements apply; and

- Claiming the credit

These credits are *nonrefundable*, so taxpayers are *not* permitted to get back more on the credit than what they otherwise owe in taxes. In addition, taxpayer cannot carry over and apply any excess credit to future tax years.

Additional Information: The IRS has also provided several valuable websites for more detailed information on these clean vehicle tax credits as follows:

- **Manufacturers and Models of Qualified Used Clean Vehicles**

- **Credits for New Electric Vehicles Purchased in 2023 or After**

- **Credits for New Electric Vehicles Purchased in 2022 or Before**

- **Commercial Clean Vehicle Credit**

- **Credits and Deductions Under the Inflation Reduction Act of 2022**

(Code §30D & Code §25E; Clean Vehicle Tax Credits)

☞**Guidance on Transferring Clean Vehicle Credits to "Eligible Entities" (Rev. Proc. 2023-33)**
This new guidance covers the transfer of new and previously-owned clean vehicle credits from the taxpayer to an "eligible entity" for vehicles placed in service *after* Dec. 31, 2023. It clarifies how taxpayers can elect to transfer new and previously-owned clean vehicle credits to dealers who are eligible to receive advance payments of either credit. The proposed regulations and revenue procedure also provide guidance for dealers to become "eligible entities" to receive advance payments of new or previously owned clean vehicle credits.

> **Comment:** Newly proposed regulations also provide guidance for the recapturing of the credit in certain instances.

> **Comment:** Taxpayers who purchase (i.e., as opposed to merely leasing) an eligible vehicle can elect to transfer the clean vehicle credit to an "eligible dealer" to reduce the cost of the vehicle instead of waiting to claim the credit once they file their return.

The revenue procedure includes those steps that a dealer would take to register with the IRS to be eligible to receive the credit transfers from taxpayers and provides details on the registration process through **IRS Energy Credits Online**. **(Code §30D(g) & 25E(f); Tax Credits)**

> **Comment:** As a result of this guidance, the IRS also updated the frequently-asked-questions (**FAQs**) for the clean vehicle credits.

☞**Leased EVs Not Entitled to Credit**
The new "clean vehicle credit" of up to $7,500 only applies to EVs that are actually acquired by the taxpayer, meaning that title to the vehicle has to have changed hands. Nevertheless, since the tax credit goes to the manufacturer or the dealer for leased Evs, lessees could still request that the dealer reduce the price of the leased vehicle by all or part of the dealer's credit amount. **(Code §30D; EV Credit)**

☞**Write-off for Installation of EV Chargers at Home**
The **Inflation Reduction Act** included a generous credit for those taxpayers considering the purchase of an electric vehicle which, in turn, necessitates the installing of an EV charger in their main home. The credit has been extended for 10 years, though 2032. It is a nonrefundable credit equal to 30% of the cost of the equipment and installation for EV home chargers or $1,000, whichever is *smaller*. Meanwhile, businesses get an even larger credit It is the *lesser* of 30% of the cost or $100,000 per EV charger that is installed on the premises after 2022. **(Code §30D; EVs)**

> **Comment:** As with any tax credit, businesses must reduce the basis in the EV charging property by the credit amount (but this remaining cost would still be eligible for both Sec. 179 immediate expensing or bonus depreciation).

☞**Updated Guidance on New Clean Vehicle Critical Mineral and Battery Components (Prop. Regs. 1.30D-1 to 4)**
The IRS has issued proposed regulations (**REG-120080-22**) related to certain requirements that must be met to qualify for the new clean vehicle credit (i.e., maximum credit of $7,500 per vehicle, $3,750 related to "critical minerals" and $3,750 related to "battery components"). To meet the "critical mineral requirement," 40% (in 2023) of the value of the critical minerals contained in the battery must be

extracted or processed in the United States, a free trade agreement country, or be recycled in North America. To meet the "battery component requirement," 50% (in 2023) of the value of the battery components must be manufactured or assembled in North America. The critical mineral and battery component requirements will apply to vehicles placed in service *on or after* 4/18/23. **(Code §30D; Clean Vehicle Credits)**

Comment: As a result of this guidance, the IRS has updated the **Frequently Asked Questions (FAQs)** for the clean vehicle credits. More importantly, clients will *not* have to guess at which vehicles qualify for these credits. There will be widely-available **lists** which will specifically identify this information.

- Imposes a new 15 percent "alternative minimum tax" (AMT) on the annual "adjusted financial statement income" (AFSI) of C corporations averaging more than $1 billion in revenue over the past three years. This tax applies to U.S. corporations with foreign parents if average 3-year revenue earned in the U.S. is $100 million or more. In addition to allowing for the use of net operating losses and foreign tax credits, it also provide for exemptions for items like general business credits and defined pension benefits. A late modification to the law also allows for the reduction of AFSI by depreciation from property under **Code §167**. "Direct pay amounts" are generally disregarded for purposes of the calculation.

Comment: The FASB, the nation's main accounting rule maker, could have congressional lobbyists devoting a great deal of interest with regard this "minimum tax rule" that would be based on "book income." And, in response, the accounting profession is expressing a great deal of concern as to how this amount will ultimately be calculated.

Comment: Corporations could owe this minimum tax when their "adjusted book income" exceeds their taxable income, mainly because of differences in book and tax accounting. But, keep in mind that this new AMT is *not* the same as the 15% minimum worldwide rate that countries are currently negotiating.

Comment: This new tax will apply to taxable years beginning January 1, 2023 and is projected to raise $222 billion over 10 years but is projected to impact only about 150 large companies.

- Imposes a new 1% excise tax on stock buy-backs by publicly traded companies. The tax, which is imposed on the corporation and is equal to 1% of the fair market value of shares repurchased, applies to stock buy-backs that occur in 2023 or later years. There is no tax if the total value of the stock repurchased in a year is $1 million or less.

Comment: Only imposed on publically traded companies, so redemptions of stock by closely-held C and S corporations would not be impacted.

Comment: This provision is projected to raise $73.7 billion over 10 years.

- Provides $80 billion to increase IRS enforcement and services. This includes the following allocations:

1) $45.6 billion to the IRS for increased enforcement. Specifically, this funding is for IRS activities to determine and collect owed taxes, to provide legal and litigation support, to conduct criminal investigations, to provide digital asset monitoring and compliance activities, to enforce criminal statutes related to tax and other financial crimes, to purchase and hire passenger motor vehicles, and to provide other services.

2) $25.3 billion to support taxpayer services and enforcement programs, including rent payments, facilities services, printing, postage, physical security, headquarters and other administrative activities, research and statistics of income, telecommunications, information technology development, enhancement, and the hiring of passenger motor vehicles.

3) $4.75 billion for business systems modernization, including the development of callback technology and other technology to provide a more personalized customer service. The funds may *not*, however, be used for the operation and maintenance of legacy systems.

4) $3.2 billion to increase taxpayer services, including pre-filing assistance and education and filing and account services.

5) $15 million to create a task force to examine the creation of an IRS-run free "direct e-file" tax return system. The task force is supposed to report back to Congress within nine months regarding the cost to build such a system, taxpayer opinions and level of trust of such a system, and opinions of independent third-parties on the feasibility, schedule, and organizational design of such a system.

Comment: This section of the **Inflation Reduction Act** legislation includes the following statement, "Nothing in this section is intended to increase taxes on any taxpayer or small business with a taxable income below $400,000. Further, nothing in this section is intended to increase taxes on any taxpayer *not* in the top 1 percent."

Comment: As far as the outcry by some pundits that lower-income taxpayers are subject to IRS audits at "five times the rate" as other more affluent taxpayers, this stems especially from the erroneous claiming of the EITC. Despite the required use of **Form 8867** and the "due diligence" information, there is still about a one-out-of-every-four-dollar mispayment rate. Also, errors involved with rebate and child tax credits will mean more possible contact with the IRS in the next few years.

Comment: The increased IRS enforcement is projected to raise $124 billion in revenue over 10 years.

- Extends the **American Rescue Plan Act** expansion of **Affordable Care Act** premium tax credits (i.e., as shown on **Form 8962**) through 2025. **ARPA** had extended these provisions only through 2022. Taxpayers with household income above 400 percent of the federal poverty level will continue to qualify for premium tax credits if the "second lowest silver plan" would cost them more than 8.5 percent of "household income." The Act also lowers the applicable percentages of household income (which determines the amount of the required premium) for all income levels. Taxpayers must only pay premiums in an amount up to the final premium percentage of household income. The premium tax credit then pays the difference.

Regs Released on Energy Credits (IR 2023-116 and IR 2023-117)

The IRS has released temporary and proposed regulations providing guidance for direct pay and transferability of some green energy focused tax credits introduced as part of the **Inflation Reduction Act** and the **CHIPS Act of 2022**. Temporary regulations (**TD 9975**) set forth mandatory information and registration requirements for qualified taxpayers planning on taking advantage of the "elective payment election" and "transferability election" options. For tax years beginning *after* 12/31/22, applicable entities can choose to make an "elective payment election" which will treat certain credits as a payment against their federal income taxes rather than as a nonrefundable credit with any excess being refundable

(**REG-101607-23**). Also, for tax years beginning *after* 12/31/22, certain eligible taxpayers can instead make an election to transfer all or some of an eligible credit to an unrelated taxpayer for cash (**REG-101610-23**). Other issues related to the advanced manufacturing credit are addressed in additional proposed regulations (**REG-105595-23**). **(Misc.; Energy Credits)**

> **Comment:** Businesses may elect to transfer 11 of the credits to unrelated third parties for cash. State and local governments and their instrumentalities, including school districts, hospitals and universities, and tax-exempt groups can elect to treat 12 of the credits as a payment of federal income tax and receive an income tax refund for the amount that exceeds their taxes. As mentioned above, the IRS has now issued proposed regs on eligibility rules and procedures for credit monetization.

☞**Top Recent Tax Developments**

Given the demands of busy season, there is no question that it is becoming increasingly more difficult to stay on top of the most important tax changes impacting our clients. Furthermore, the complexity of the tax law is only becoming more extreme with each new piece of legislation Congress passes (with even some of the provisions being retroactive). Below is a brief summary of the more significant developments you should be aware of heading into the 2023 busy season:

1. Proposed regs under Code §408 - SECURE Act changes: This 275-page set of proposed regulations provides guidance to the required minimum distribution rules as a result of the **SECURE Act** passed in 2019 (which was effective as of 1/1/2020). Under the regs, annual distributions will be required *prior to* the 10-year deadline for removing the account balance if the decedent had already reached the "required beginning date" before their death. On the other hand, annual RMDs by the beneficiary will *not* be required if the decedent had *not* reached this key date (i.e., starting in 2023, at 73 years old).

> **Comment:** Looking at the original language in the statute, there is no mention of this requirement. As a result, tax experts were unanimous in stating that complete removal of the funds in an inherited retirement plan or IRA could wait literally until the last day of the tenth year following the year in which the plan owner had passed away. Now, more than two years later, the retirement plan experts at the Treasury are promulgating these regs which would have an *retroactive* effect on distributions which should have already been made in the first two years impacted by the **SECURE Act** (i.e., namely, 2020 and 2021), subject to the 50% penalty for failing to do so.

2. Proposed regs under Code §2010: These regulations provide assurance that 2018-2025 gifts will generally remain nontaxable even if larger than the post-2025 exemption at death (i.e., should the current unified credit equivalent amounts, as adjusted for inflation over this time period, *not* be retained once the **TCJA** provisions expire). However, the rule will generally *not* apply to pre-2026 transfers that are ultimately includible in a decedent's gross estate (i.e., because the unified credit equivalent that existed at the time that a previously gift was made was insufficient to offset the potential gift tax).

> **Comment:** For 2023, the estate tax "unified credit equivalent" is $12,920,000 meaning that a married couple could pass through up to $25,840,000 in assets to their beneficiaries without any transfer (i.e., gift or estate) tax otherwise being due.

3. Gericke v. Truist: The 3rd Circuit Court of Appeals agreed with a New Jersey federal district court that ***Truist*** properly issued a **Form 1099-C** to the plaintiff given that the applicable regulations require issuance of the form on an "identifiable event" including a creditor's decision to discontinue collection activity. The court clarified that the **Form 1099-C** "is *not* a means of accomplishing an actual discharge of debt" meaning that collection activity could resume. The end result is that the individual had to deal with the issue of whether this cancellation of debt (COD) income had to be included in gross income (unless an exception under **Code §108** apply and **Form 982** was properly filed).

4. Blum v. Commr.: The 9th Circuit Court of Appeals agreed with the Tax Court that payments for legal malpractice in mishandling a physical injury suit are taxable to the recipient since the wording of the settlement clearly indicated that it was entered to compensate the plaintiff for "the harm caused by the malpractice, rather than for the physical injuries sustained in the underlying negligence action" (i.e., which is a prerequisite to exclusion under **Code §104**).

5. Morgan v. Commr.: The Tax Court determined that an individual who met the "330-in-365-days-physical-presence test" was treated as having his tax home in Saudi Arabia where he worked under a U.S. government contract. A key factor was that he had "significant community involvement and stronger ties to Saudi Arabia than he did to the United States," in spite of the fact that he retained an unrented home in the United States that was used by his daughter.

> **Comment:** As a result, he was entitled to exclude under **Code §911** up to $112,000 (i.e., for 2022) of his foreign earned income from U.S. taxation. Also, since his "tax home" was deemed to be in Saudi Arabia, his travel expenses for business purposes from away from that location were tax deductible.

6. Musselwhite v. Commr.: After considering eight critical factors, the Tax Court found six of them in favor of the IRS, determining that a loss on the sale of four lots by a personal injury lawyer was capital in nature rather than ordinary. One of the key factors was that the taxpayer used the term "investments" in the entity name and in the description of the purpose of the entity.

> **Comment:** Even though the taxpayer had been involved in real estate development activities for 30 years, the manner in which this particular venture was handled indicated that it was still in the "investment phase." That is, not enough development related activity had taken place to change these lots into "inventory" which would have resulted in a ordinary loss upon their eventual sale.

7. Milkovich v. U.S.: A divided 9th Circuit Court of Appeals *reversed* a Washington federal district court and allowed a bankrupt couple, whose recourse home mortgage was converted to nonrecourse on filing a bankruptcy, to deduct over $100,000 in interest being paid at the time of a short sale despite *not* having to report relief from indebtedness income due to insolvency.

> **Comment:** The taxpayers took out a mortgage in connection with purchasing a home, and eventually filed for bankruptcy. When the bankruptcy petition was discharged, their mortgage loan changed from "recourse" to "nonrecourse." This eliminated the lender's pre-existing ability to enforce the mortgage debt personally against taxpayers, and instead limited the bank to enforcing only the value of its lien. The bank then received about $522,015 from the short sale of the house, credited $114,688 of it toward the accumulated unpaid interest on the secured loan, and credited the remaining amount toward paying off the loan principal (i.e., instead of crediting the entire amount received solely against the principal balance outstanding). Taxpayers claimed a $114,688 mortgage interest deduction for that year. The IRS had attempted disallowed the deduction under **Code §265(a)(1)**.

8. State of New York v. Yellen: The U.S. Supreme Court declined to review the holding (i.e., grant a writ of certiori) of the 2nd Circuit Court of Appeals permitting the $10,000 limitation on the deduction of state and local taxes to stand.

Comment: Going into this busy season, there is nothing that is going to change this limitation for the 2023 tax year. Only an election to pay the "passthrough entity tax" (PTET) on the entity return, if permitted by the state, would mitigate the effect of this cap.

Comment: This is not a surprising result insomuch as the federal government is well within its rights to modify or repeal various deductions, including those claimed on **Schedule A**. But, almost every state which imposes state income taxes on flowthrough entities has considered, or otherwise put into place, an **election** to treat these partnerships and S corporations the same as regular C corporations with any state income taxes instead being imposed at the entity level v. on the owner's personal **Form 1040**. As a result, this "cost" is treated the same as any other expense on the front page of the entity's tax return (i.e., the same as insurance, utility, and other business expenses). Of course, this added "expense" does serve to reduce "qualified business income" flowing through to the K-1 owners for purposes of the **Code §199A** 20% deduction. Furthermore, this alternative approach works best, from a tax savings standpoint, when the owner is in the higher marginal rates of 32%, 35% or 37%.

9. Hewitt v. Commr.: The 11th Circuit Court of Appeals *reversed* the Tax Court and found IRS regulations "were improperly developed and were arbitrary and capricious," which would have taken away a deduction for donation of a conservation easement because improvements to the area of the easement would *not* have inured on a subsequent sale in at least pro rata part to the donee organization.

Comment: In ***Oakbrook Landholdings, LLC v. Commr.*, 129 AFTR2d 2022-1031 (3/14/2022)**, the 6th Circuit Court of Appeals had instead *agreed* with the Tax Court, under similar facts.

Comment: Regardless of these specific regulations on conservation easements, the overall key to claiming a deduction for such donations is the proper completion of **Form 8283**. Especially for larger non-property donations there are so many pitfalls to be avoided when including that form with your personal return that would cause the deduction to be denied. It would be best to solicit a firm that specializes in these types of charitable donations for assistance.

10. Kellett v. Commr.: The Tax Court confirmed that a business information website activity actually rose to the level of being a trade or business with deductible rather than amortizable "start-up expenses" when the website's functionality was finally completed (which was four years prior to actual profitability of this business).

Comment: The IRS disallowed a $25,922 business expense deduction and determined a corresponding $6,475 deficiency for petitioner's 2015 tax year. The issue for the Tax Court was what portion of these expenditures petitioner would be permitted to deduct on his 2015 federal income tax return as costs of developing a business information website. The taxpayer's active trade or business was considered to have began when he opened his website to the public in September 2015. Therefore, **Code §162(a)** allowed the taxpayer to deduct the $8,087 of business-related expenditures he paid thereafter as trade or business expenses. On the other hand, **Code §195(b)(1)(B)** required him to ratably deduct the remaining $16,553 of business-related expenditures as "start-up expenditures" over the 180-month period beginning with September 2015.

Comment: Although the court cited **Code §195(b)(1)(B)** for deductibility purposes, IRS **Notice 2000-50** allows for software development costs (such as those involved with the creation of a website) to be amortized over a 60-month period.

11. Hoffman v. Signature Bank of Georgia: The 11th Circuit Court of Appeals *reversed* a Georgia federal district court and held that Roth IRAs enjoy the *same* protection from creditors under federal law as do traditional IRAs.

12. Hood v. Commr.: The Tax Court, using a "multi-factor approach," allowed a deduction by a C corporation for about one half of a $5 million bonus paid in two consecutive years to the owner of a highly successful construction company above and beyond about the $200,000 in straight W-2 compensation. A key factor in the eyes of the court was that the owner worked 60- to 70-hour weeks and grew the company from scratch to about $70 million in revenue.

> **Comment:** The "mathematics" behind deductible compensation to a C corporation as opposed to a nondeductible dividend is now basically a moot point. Consider a $100 profit paid as wages which could be taxed at up to 37%, plus a possible 3.8% Medicare surtax (i.e., as shown on **Form 8959**), for a total effective tax rate of 40.8%. On the other hand, a nondeductible dividend would result in a federal income tax of a flat 21% to the corporation. Then, up to a 20% LTCG rate, plus a 3.8% Medicare surtax could apply at the shareholder level, for a total of 39.8% (i.e., 21% + (23.8% x $79 after-tax dividend out of the $100 of C corporation profit).
>
> **Comment:** In 1980, the taxpayer and his wife founded and were the sole shareholders and members of the board of Clary Hood, Inc., a subchapter C corporation. Due to taxpayer's leadership and work ethic, the company was successful, having revenue of near $44 million (net $7 million) in 2015 and $68 million (net $14 million) in 2016. The taxpayer and his wife set the level of his compensation. In 2014, the taxpayer and his advisors concluded that he "had been under compensated in prior years." As a result, for 2015, the taxpayer and his wife set his salary at $168,559 and his bonus at $5 million. Similar compensation and bonus was approved for 2016. On the other hand, the taxpayer set the other four executives' compensation, none of whom were compensated in excess of $234,000 and none had a bonus greater than $100,000. The IRS issued a notice of deficiency, claiming that the compensation for the years at issue exceeded "reasonable compensation" under **Code §162(a)(1)** (i.e., and, therefore, should be recharacterized as "disguised dividend"). This resulted in total deficiencies of $1,581,202 and $1,613,308 for taxpayer's 2015 and 2016 tax years, respectively. The IRS also attempted to assess accuracy-related penalties under **Code §6662** for underpayments due to "substantial understatements" of income tax of $316,240 and $322,662.

13. Donoghue v. Commr.: The U.S. Supreme Court declined to hear an appeal from the 1st Circuit Court of Appeals that had upheld a Tax Court decision finding that the breeding, racing and selling of horses was *not* an activity engaged in for profit where there was *not* a single year with positive earnings in 30 years (i.e., it was instead deemed to be a "hobby loss" situation).

> **Comment:** After the passage of the **TCJA**, the treatment of a proposed business endeavor as instead a "hobby" is even worse than the non-deductibility of expenses for a marijuana business (where, at least, the cost of goods sold is allowed as a deduction). Under the "hobby loss" rules, *all* gross receipts have to be included as "Other Income" on **Schedule 1** of **Form 1040** with absolutely none of the related expenses being allowed, even where the taxpayer otherwise itemizes their deductions on **Schedule A**, since "2% miscellaneous deductions" have been completely eliminated.

14. Oosterwijk v. U.S.: A Maryland federal district court refused to abate substantial penalties when a taxpayer's CPA firm failed to file an extension and subsequently incorrectly advised the taxpayer that penalties would stop with a late-filed extension. The special "first-time penalty abatement policy" did *not* apply because it had been used for a $7 abatement several years earlier.

Comment: The taxpayers owned a small meat stall, which they grew into a thriving meat wholesaler over the course of 24 years. In 2017, they sold the business, and the transaction complicated their taxes that year. For over ten years their CPA handled their taxes, including preparing and filing extension requests and income tax returns. Their tax compliance record was clean except for a $7 late payment penalty incurred in 2014 which was waived under the IRS's **First Time Penalty Abatement Policy**. In the year that the taxpayers sold their business, they decided to extend their return and the CPA informed them that he had successfully e-filed **Form 4868** and that the $1.8 million in tax due would be automatically debited from their bank account. When this withdrawal did *not* take place, with the taxpayers continually kept in touch with the CPA about the situation. The CPA eventually discovered that the extension form had *not* been filed, but assured them that as long as they filed their return and paid the tax by the Oct. 15, 2018 extended due date, no interest or penalties would be assessed. In reality, the taxpayers were assessed a total of $274,634.74 in failure-to-file penalties and accrued interest.

15. Bittner v. U.S.: The U.S. Supreme Court agreed to review a decision of the 5th Circuit Court of Appeals, in which the court held that the penalty for a "nonwillful FBAR violation" is on an "account-by-account basis" each year, instead of on a "per-taxpayer basis," which resulted in a penalty over five years of $2.72 million, rather than $50,000.

Comment: This has been resolved now and the penalty is on a "per-taxpayer" basis as opposed to each and every account that is *not* reported by the taxpayer.

16. Jones v. U.S.: The 9th Circuit Court of Appeals *agreed* with the Tax Court that a former wife "tacitly consented" to the filing of a joint return which she did *not* actually sign, "by virtue of providing the tax information and *not* filing a separate return." The court then found that "the factors on balance weighed *against* providing innocent spouse relief," especially because of the knowledge of the "likely inability to pay the liability and a history of noncompliance."

Comment: The Tax Court was found to have "correctly articulated the governing legal standard," due to the fact that the taxpayer tacitly consented to filing the 2010 joint tax return because: (1) she had provided her then-husband with her W-2s and other tax information; (2) she failed to file a separate income tax return; and (3) she later allowed her spouse in a subsequent marriage to sign her name to their joint tax returns.

17. In re Golden: A California bankruptcy court decided against the weight of recent authority and allowed an individual to discharge income tax liability for a year in which a substitute for return was prepared by the IRS prior to the actual filing of the return. The court took note of the fact that "financial and family difficulties prevented timely filing, the return was filed within a reasonable amount of time from the extended due date (17 months) and the late filed return reduced the assessed tax."

18. IRS Fact Sheet 2022-20: The service stated that issuance of a **Form 1099-K** from money raised on a "crowdfunding" website does *not* automatically cause taxation to the person receiving the form, and that facts and circumstances must be examined to determine whether these amounts are gifts.

Comment: Prior to 2022, the threshold for a crowdfunding website or payment processor to file and furnish a **Form 1099-K** was met if, during a calendar year, the total of all payments distributed to a person exceeded $20,000 in gross payments resulting from more than 200 transactions or donations. On the other hand, for calendar years beginning *after* December 31, 2023, the threshold is lowered and is met if, during a calendar year, the total of all payments distributed to a person exceeds $600 in gross payments, *regardless* of the number of transactions or donations.

Comment: The handling of **Form 100-Ks** will be one of the more demanding issues that we will face for this 2023 busy season.

Comment: According to this IRS "Fact Sheet," if a crowdfunding organizer solicits contributions on behalf of others, distributions of the money raised to the organizer may *not* be includible in the organizer's gross income if the organizer further distributes the money raised to those for whom the crowdfunding campaign was organized. Furthermore, if crowdfunding contributions are made as a result of the contributors' "detached and disinterested generosity," and without the contributors receiving or expecting to receive anything in return, the amounts may be treated as "gifts" and therefore may *not* be includible in the gross income of those for whom the campaign was organized.

19. Government Accountability Office Report: The report indicated that the IRS audit rate of individual tax returns has declined to 0.25%, down from 0.9% a decade ago and even further from earlier years.

Comment: With a proposed $80 billion infusion to the IRS budget because of the recent passage of the **Inflation Reduction Act**, there will be a marked increase in audits for all taxpayers, especially partnership tax returns and those individuals in the higher income brackets.

20. CCA 202204007: The IRS ruled that a C corporation that provides a search website for rental properties (e.g., **Airbnb** or **VRBO**) is a "broker company" providing services and is therefore ineligible for the 100% "qualified small business" exclusion under **Code §1202** with regard to gain realized on the sale of their stock.

Comment: How prevalent was the potential **Code §1202** during this most recent tax year?

☞**Selected Business Tax Provisions Expired or Phased Out**

The following tax provisions impacting business clients have either expired, or otherwise been modified/phased out, as of the end of the 2021 tax year (except for bonus depreciation) and therefore should be kept in mind when doing tax planning for your clients in 2022 and 2023:

- Bonus depreciation is scheduled to drop from 100% to 80% for otherwise qualifying assets placed into service after 12/31/2022.

- Full expensing of R&D costs (i.e., under **Code §174**) changes from 2021 to a 5 year amortizing asset deduction in 2022 (and, continuing for 2023).

- The business interest expense deduction (i.e., under **Code §163(j)**) goes from 30% of EBITDA in 2021 to 30% of EBIT in 2022 (and, continues for 2023).

- The **Form 1099-K** reporting threshold of $20,000 for 2021 has been dropped to $600 for 2022 (and, the number of overall transactions no longer matters).

- The Employee Retention Credit for all businesses, including startups, expired at the end of 2021, although it may still be claimed on amended **Form 941's** for 2021 and 2020 (i.e., 3-year period to amend using **Form 941X**).

Comment: How important is the recent IRS "reprieve" for erroneous ERC claims?

- The special 3-year MACRS recovery period for racehorses two years old or younger also reverted back to 7 years for 2022

INDIVIDUAL TAXATION:

Miscellaneous:

☞**Selected Individual Tax Provisions Expired or Phased Out**

The following tax provisions impacting individual filers have either expired, or otherwise been modified/phased out, as of the end of the 2021 tax year and therefore should be kept in mind when doing tax planning for your clients in 2023:

- The 1-year only increase in the child credit expired at the end of 2021. This credit reverted back to $2,000 (from $3,000); reduced the age back to under 17 (from under 18); is no longer fully refundable ($1,400 max); and reverts back to lower income phaseouts.

> **Comment:** If we see any new tax legislation in the next few months, such as retaining 100% for bonus depreciation, 50% of ATI before amortization and depreciation, or restoring R&D costs as a tax credit, the Democrats are insisting on restoring the higher levels for these child tax credits.

- The 1-year only increase in the dependent care credit (i.e., on **Form 2441**) also expired at the end of 2021. It reverts back to 20% (from 50%); reverts back to a very low AGI phaseout (at $15,000 it begins reducing from 35% to 20%); and lowers qualified expenses back to $3,000 for 1 child ($6,000 for >1) from the one year only amounts of $8,000 and $16,000.

- The $600 charitable deduction amount for married taxpayers otherwise choosing to use the standard deduction amount expired at the end of 2021.

- The 2021 increases to the earned income credit for taxpayers without children and for older and younger Americans reverts back to 2020 rules.

- The 100% of AGI charity deduction for cash contributions reverted back to a 60% limit.

- The credits for nonbusiness energy property (insulation, storm windows and doors, etc.) and alternative fuel refueling (electric car chargers) were scheduled to expire at the end of 2021. However, the **Inflation Reduction Act** has now restored them for ten more years and increased the amounts otherwise allowed.

- The deduction for mortgage insurance premiums as mortgage interest expired at the end of 2021.

- Cafeteria plan deferrals for child care revert back to a maximum of $5,000 (i.e., where you have two or more children in child care) from $10,500.

☞**Minor Changes to 2023 Form 1040**

The **Form 1040** for 2023 will basically be the same as that used for the 2022 tax year. That also applies to both **Schedules 1** and **2**. But **Schedule 3** will have a few changes to reflect the newly-expanded energy credits for adding eco-friendly upgrades to your residence. There is also a *new* line to claim the credit for buying a used electric vehicle in 2023. And, **Part II** of **Schedule 3** is shortened to reflect tax provisions no longer in effect. **(Misc.; 2023 Form 1040)**

☞Key Inflation-Adjusted Numbers for 2023 Tax Year

The income tax brackets, standard deduction amounts, and many other tax items are adjusted annually for cost-of-living increases and reflect the "average chained Consumer Price Index (CPI)" for all-urban customers (C-CPI-U) for the 12-month period ending the previous August 31. Based on the August 2022 CPI summary released by the Labor Department and using the chained CPI for August 2022 (and the preceding 11 months), the key 2023 indexed amounts are listed below.

Tax Rate Schedules:

For married individuals filing joint returns and surviving spouses:

- If taxable income is under $22,000; the tax is 10% of taxable income

> **Comment:** With a standard deduction of $27,700 ($30,700 for MFJs 65 or older), the tax would be only $2,200 (i.e., 10% x $22,000) on up to approximately $50,000 of ordinary taxable income. And, of course, additional income could be sheltered with retirement plan or IRA contributions.

- If taxable income is over $22,000 but not over $89,450; the tax is $2,200.00 plus 12% of the amount over
$22,000

- If taxable income is over $89,450 but not over $190,750; the tax is $10,294.00 plus 22% of the amount over $89,450

- If taxable income is over $190,750 but not over $364,200; the tax is $32,580.00 plus 24% of the amount over $190,750

- If taxable income is over $364,200 but not over $462,500; the tax is $74,208.00 plus 32% of the amount over $364,200

- If taxable income is over $462,500 but not over $693,750; the tax is $105,664.00 plus 35% of the amount over $462,500

- If taxable income is over $693,750; the tax is $186,601.50 plus 37% of the amount over $693,750

For single individuals (other than heads of households and surviving spouses):

- If taxable income is not over $11,000; the tax is 10% of taxable income

> **Comment:** With a standard deduction of $13,850, only a tax of $1,100 would be due on up to $24,850 of ordinary income (with the ability to shelter more income with retirement plan or IRA contributions).

> **Comment:** Remember to file appropriate **Form W-4s** to claim exemption from, at least, federal income tax withholding for those dependent taxpayers, for instance, who are only working a summer or part-time job.

- If taxable income is over $11,000 but not over $44,725; the tax is $1,100.00 plus 12% of the amount over $11,000

- If taxable income is over $44,725 but not over $95,375; the tax is $5,147.00 plus 22% of the amount over $44,725

- If taxable income is over $95,375 but not over $182,100; the tax is $16,290.00 plus 24% of the amount over $95,375

- If taxable income is over $182,100 but not over $231,250; the tax is $37,104.00 plus 32% of the amount over $182,100

- If taxable income is over $231,250 but not over $578,125; the tax is $52,832.00 plus 35% of the amount over $231,250

- If taxable income is over $578,125; the tax is $174,238.25 plus 37% of the amount over $578,125

For heads of household:

- If taxable income is not over $15,700: the tax is 10% of taxable income If taxable income is over $15,700 but not over $59,850; the tax is $1,570.00 plus 12% of the excess over $15,700

- If taxable income is over $59,850 but not over $95,350; the tax is $6,868.00 plus 22% of the excess over $59,850

- If taxable income is over $95,350 but not over $182,100; the tax is $14,678.00 plus 24% of the excess over $95,350

- If taxable income is over $182,100 but not over $231,250; the tax is $35,498.00 plus 32% of the excess over $182,100

- If taxable income is over $231,250 but not over $578,100; the tax is $51,226.00 plus 35% of the excess over $231,250

- If taxable income is over $578,100; the tax is $172,623.50 plus 37% of the excess over $578,100

For married individuals filing separate returns:

- If taxable income is not over $11,000; the tax is 10% of taxable income

- If taxable income is over $11,000 but not over $44,725 the tax is $1,100.00 plus 12% of the excess over $11,000

- If taxable income is over $44,725 but not over $95,375; the tax is $5,147.00 plus 22% of the excess over $44,725

- If taxable income is over $95,37595,375 but not over $182,100; the tax is $16,290.00 plus 24% of the excess over $95,375

- If taxable income is over $182,100 but not over $231,250; the tax is $37,104.00 plus 32% of the excess over $182,100

- If taxable income is over $231,250 but not over $346,875; the tax is $52,832.00 plus 35% of the excess over $231,250

- If taxable income is over $346,875; the tax is $93,300.75 plus 37% of the excess over $346,875

For estates and trusts:

- If taxable income is less than $2,900; the tax is 10% of taxable income

- If taxable income is over $2,900 but not over $10,550; the tax is $290.00 plus 24% of the excess over $2,900

- If taxable income is over $10,550 but not over $14,450; the tax is $2,126.00 plus 35% of the excess over $10,550

- If taxable income is over $14,450; the tax is $3,491.00, plus 37% of the excess over $14,450

Standard deductions:

The basic standard deduction for 2023 will be:

- Joint return or surviving spouse $27,700 ($25,900 for 2022)

- Single (not head of household or surviving spouse) $13,850 ($12,950 for 2022)

- Head of household $20,800 ($19,400 for 2022)

- Married filing separate returns $13,850 ($12,950 for 2022)

> **Comment:** With the dramatic increase in the rate of inflation, you can now see how it impacts the annual increases to these key tax numbers.

Standard deductions - Dependents:

For an individual who can be claimed as a dependent on another's return, the basic standard deduction for 2023 will be $1,250 ($1,150 in 2022), or $400 ($400 in 2022) plus the individual's *earned* income, whichever is greater. However, the standard deduction may *not* exceed the regular standard deduction for that individual.

Standard deductions - Older and blind taxpayers:

For 2023, the additional standard deduction for married taxpayers 65 or over or blind will be $1,500 ($1,400 in 2022). For a single taxpayer or head of household who is 65 or over or blind, the additional standard deduction for 2023 will be $1,850 ($1,750 in 2022).

Exemption amount:

While the dependency exemption deduction under **Code §151** is reduced to zero from 2018 through 2025, this reduction is *not* taken into account for other purposes of the Code, such as who is a "qualifying relative" for family credit purposes, as well as eligibility for head-of-household status. For 2023, this amount is $4,700 ($4,400 in 2022).

Capital gains:

For 2023, the capital gains tax rates will be as follows:

The **0% capital gains rate** applies to adjusted net capital gain of up to:

- Joint returns and surviving spouses - $89,250 ($83,350 in 2022)
- Single filers and married taxpayers filing separately - $44,625 ($41,675 in 2022)
- Heads of household - $59,750 ($55,800 in 2022)
- Estates and trusts - $3,000 ($2,800 in 2022)

The **15% capital gains rate** applies to adjusted net capital gain over the amount subject to the 0% rate, and up to:

- Joint returns and surviving spouses - $553,850 ($517,200 in 2022)
- Married taxpayers filing separately - $276,925 ($258,600 in 2022)
- Heads of household - $523,050 ($488,500 in 2022)
- Single filers - $492,300 ($459,750 in 2022)
- Estates and trusts - $14,650 ($13,700 in 2022)

The **20% capital gains rate** applies to adjusted net capital gain over the above 15% maximum amounts.

> **Comment:** There is still an obvious "marriage penalty" as the $553,850 amount above for MFJ filers is not twice the $459,750 available for single taxpayers. And, again for 2023, the top 20% rate for LTCGs has nothing to do with where the top 37% marginal rate applies for ordinary income.

Kiddie Tax:

The exemption from the kiddie tax for 2023 (i.e., due to the $1,250 standard deduction and the fact that the next $1,250 of unearned income is tax to the child) will be $2,500 ($2,300 in 2022). As an alternative, the parent continues to be able to elect (i.e., on **Form 8814**) to include a child's unearned income on the parent's return for 2023 if the child's income is more than $1,250 and less than $12,500 ($1,150 and $11,500 in 2022).

> **Comment:** Under the "assignment of income" doctrine, remember that "earned income" is never taxed to anyone other than the person that is entitled to it (i.e., regardless of age and whether or not that person's unearned income is subject to kiddie tax).

> **Comment:** Although a "kiddie" (i.e., those individuals under age 19, or a full-time student under age 24) might be subject to taxation on their unearned income based on their parents' marginal rate, they would *not* be subject to the **Code §1411** 3.8% Medicare surtax unless their modified AGI is above $200,000.

Comment: One way to avoid the kiddie tax would be to keep, for instance, a college student's credit hours just one or two credit shy of "full-time status" (i.e., with this "kiddie" taking a summer school course to make up the deficit).

AMT Rates & Exemption Amounts:

For 2023, the AMT exemption amounts will be:

- Joint returns or surviving spouses - $126,500 ($118,100 in 2022)

- Unmarried individuals (other than surviving spouses) - $81,300 ($75,900 in 2022)

- Married individuals filing separate returns-$63,250 ($59,050 in 2022)

- Estates and trusts-$28,400 ($26,500 in 2022)

For 2023, the "excess alternative minimum taxable income" above which the 28% tax rate applies (i.e., as opposed to the initial 26% rate) will be $110,350 for single taxpayers (or, married persons filing separately) ($103,050 in 2022), and $220,700 for joint returns, unmarried individuals and estates and trusts ($206,100 in 2022).

For 2023, the amounts used under **Code §55(d)(3)** to determine the phaseout of the AMT exemption amounts will be:

- Joint returns or surviving spouses - $1,156,300 ($1,079,800 in 2022)

- Unmarried individuals (other than surviving spouses) - $578,100 ($539,900 in 2022)

- Married filing separate returns - $578,150 ($539,900 in 2022)

- Estates and trusts-$94,600 ($88,300 in 2022)

Comment: Due to the fact that taxpayers have a much larger AMT exemption amount (i.e., after the 1/1/2018 effective date of the **TCJA**) and that it also phases out at a much higher level of AMTI, in addition to *not* having as many AMT "preference items" (e.g., personal and dependency exemptions, state and local taxes, consumer interest allowed under the former "qualified equity indebtedness" exception, and 2% miscellaneous deductions), means that very few (i.e., when compared to pre-2018 tax years) taxpayers are now subject to AMT. And, of course, wealthier taxpayers falling in the marginal tax rate of 37% far outpace the AMT generated by the top 28% rate on AMTI.

Phaseout on Sec. 199A 20% qualified business income deduction:

For 2023, taxpayers with taxable income above $182,100 for single and head of household returns, $364,200 for joint filers, and $182,100 for married filing separate returns are subject to certain phaseout limitations on the **Code §199A** deduction. The 2022 amounts were $170,050, $340,100, and $170,050.

Comment: These phaseout rules come into play when the taxpayer's taxable income *before* the Sec. 199A deduction is taken into account exceeds the end of the 24% tax bracket for their respective filing status.

Comment: For example, there are three distinct "brackets" (using amounts for MFJ filers) when determining the Sec. 199A deduction:

1. If the MFJ taxable income, before any Sec. 199A deduction, is below the end of the 24% bracket (i.e., $364,200 for 2023), then the full 20% deduction is normally available, regardless of whether the QBI comes from SSTB, non-SSTB, or rental income.

2. If the MFJ taxable income, before any Sec. 199A deduction, is below the end of the 24% bracket (i.e., $364,200 for 2023), and $464,200 (i.e., within the $100,000 phaseout range), then the 20% deduction is proportionally phased out, with any deduction attributable to SSTB QBI completely eliminated as the taxable income exceeds this upper limit.

3. If the MFJ taxable income, before any Sec. 199A deduction, is above $464,200, then only QBI form non-SSTB sources might be eligible for the 20% deduction, but only if it is fully supported by either 2.5% of UBIA and/or 50% of wages.

Comment: Keep in mind that "excess QBLs" (i.e., "qualified business losses") need to be carried over to future tax years regardless of the level of the taxpayer's taxable income. And these losses need to be distinguished from those losses disallowed due to the lack of basis, at-risk basis, the passive loss rules, or the EBL cap under **Code §461(l)** (as discussed below).

Code §461(l) "excess business loss" disallowance rule:

Under **Code §461(l)**, an "excess business loss" for the tax year is the excess of aggregate deductions of the taxpayer attributable to the taxpayer's trades and businesses, over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. For 2023, the threshold amount is $578,000 for married individuals filing jointly ($540,000 in 2022) and $289,000 for other individuals ($270,000 in 2022).

Comment: This EBL restriction represents the "fourth barrier" to taking losses. It applies, for instance, to K-1 losses after taking into account: (1) basis limitations; (2) at-risk limitations; and (3) passive loss rules. The EBL cap does *not*, however, restrict the capital losses as long as the taxpayer has sufficient capital gains (or, net Sec. 1231 gains and unrecaptured Sec. 1250 gains) to offset this amount.

Educator expenses:

For 2023, eligible elementary and secondary school teachers can claim a for-AGI deduction for up to $300 per year of expenses paid for books and certain other supplies used in the classroom ($300 in 2022). And, two married educators, the aggregate cap would be $600 (i.e., $300 for each spouse).

Comment: COVID "personal protection equipment" costs that the educator incurs related to their teaching position continue to qualify for this deduction.

Interest exclusion for higher education:

For 2023, the phase-out for excluding interest on U.S. savings bonds redeemed to pay qualified higher education expenses will begin at modified adjusted gross income (MAGI) above $91,850 ($137,800 on a joint return). For 2022, the corresponding figures were $85,800 and $128,650.

Qualified transportation fringe benefits:

For 2023, an employee will be able to exclude up to $300 ($280 in 2022) a month for qualified parking expenses, and up to $300 a month ($280 in 2022) of the combined value of transit passes and transportation in a commuter highway vehicle.

Refundable child credit:
Under **Code §24(d)** the child credit is refundable, subject to the limit described below, to the extent of the *greater* of:

- 15% of earned income above $2,500, or

- For taxpayers with three or more qualifying children, the excess of the taxpayer's social security taxes for the tax year over their earned income tax credit for the year. Nevertheless, the refundable portion of the child tax credit for any qualifying child cannot exceed $1,600 for 2023.

> **Comment:** The credit amount continues to be $2,000 (as opposed to the $3,600 or $3,000 amounts which applied to the 2021 tax year).

Earned income tax credit:
For 2023, the maximum amount of earned income on which the earned income tax credit will be computed is $7,840 for taxpayers with no qualifying children, $11,750 for taxpayers with one qualifying child, and $16,510 for taxpayers with two or more qualifying children.

> **Comment:** According to a recent TIGTA audit report, the error rate continues to be around 23% of these credits being paid out by the federal government.

For 2023, the phaseout of the allowable earned income tax credit will begin at $16,370 for joint filers with no qualifying children ($9,800 for others with no qualifying children), and at $28,120 for joint filers with one or more qualifying children ($21,560 for others with one or more qualifying children). The amount of disqualified income (generally investment income) a taxpayer may have before losing the entire earned income tax credit is $11,000 for 2023.

> **Comment:** Taxpayers are required use the IRS tables to determine the amount of their earned income tax credit. While these tables are based on the inflation-adjusted figures set out above, because the credit under the tables is the same for everyone within a $50 range, there may be slight differences between the credit under the tables and the credit the taxpayer would determine using those inflation-adjusted figures.

> **Comment:** Furthermore, **Form 8867** must be included with their return in order to satisfy the "due diligence" requirements when claiming the EITC, along with several other credits and head of household filing status.

Adoption credit:
For 2023, the credit allowed for an adoption of a child with special needs will be $15,950 (i.e., regardless of the actual costs incurred) ($14,890 in 2022). The maximum credit allowed for other adoptions will be the amount of qualified adoption expenses up to $15,950 ($14,890 in 2022).

For 2023, the credit will begin to phase out for taxpayers with MAGI in excess of $239,230 ($223,410 in 2022). The phaseout will be complete if MAGI is $279,230 ($263,410 in 2022).

Adoption exclusion:
For 2023, the amount of employer adoption assistance that can be excluded from an employee's gross income for the adoption of a child will be $15,950 ($14,890 in 2022). In the case of an adoption of a child with special needs, the amount that can be excluded will also be $15,950 ($14,890 in 2022).

Comment: The employer-provided adoption benefits are amounts your employer paid for qualified adoption-related expenses to you directly or to a third party on your behalf. You can exclude these benefits from your taxable income up to $14,890 for 2022 and $15,950 for 2023.

For 2023, the amount excludible from an employee's gross income will begin to phase out for taxpayers with MAGI in excess of $239,230 ($223,410 in 2022). The phaseout will be complete if MAGI is $279,230 ($263,410 in 2022).

Student loan interest deduction:
For 2023, the deduction phases out ratably for taxpayers other than joint filers with MAGI between $75,000 and $90,000 ($70,000 and $85,000 in 2022), and MAGI between $155,000 and $185,000 for joint filers ($145,000 and $175,000 in 2022).

Comment: Remember, the $2,500 overall limit per year stays the same for MFJ filers.

MAGI limits - deductible contributions by active plan participants to traditional IRAs:
Normally, an individual who is *not* an "active participant" in certain employer-sponsored retirement plans, and whose spouse is also *not* an active participant, may make an annual deductible cash contribution to an IRA up to the *lesser* of: (1) an inflation-adjusted statutory dollar limit, or (2) 100% of the compensation that is includible in his or her gross income for that year. For 2023, the statutory dollar limit is $6,500 ($6,000 in 2022), plus an additional $1,000 for those age 50 or older.

If the individual (or his or her spouse) is an "active plan participant," the deduction phases out over a specified dollar range of MAGI. For taxpayers filing joint returns, the otherwise allowable deductible contribution will be phased out ratably for 2023 for MAGI between $116,000 and $136,000 ($109,000 and $129,000 in 2022).

For 2023, for single taxpayers and heads of household, the otherwise allowable deductible contribution will be phased out ratably for MAGI between $73,000 and $83,000 ($68,000 and $78,000 in 2022). For married taxpayers filing separate returns, the otherwise allowable deductible contribution will be phased out ratably for MAGI between $0 and $10,000 ($0 and $10,000 in 2022).

For a married taxpayer who is *not* an active plan participant but whose spouse is such a participant, the otherwise allowable deductible contribution will be phased out ratably for 2023 for MAGI between $218,000 and $228,000 ($204,000 and $214,000 in 2022).

MAGI limits - contributions to Roth IRAs:
Individuals may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions (i.e., $6,500 in 2023 ($6,000 in 2022), plus an additional $1,000 for those age 50 or older).

The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with MAGI over certain levels for the tax year. For taxpayers filing joint returns, the otherwise allowable contributions to a Roth IRA will be phased out ratably for 2023 for MAGI between $218,000 and $228,000 ($204,000 and $214,000 in 2022).

For single taxpayers and heads of household, it will be phased out ratably for MAGI between $138,000 and $153,000 ($129,000 and $144,000 in 2022). For married taxpayers filing separate returns, the otherwise allowable contribution will continue to be phased out ratably for MAGI between $0 and $10,000 ($0 and $10,000 in 2022). **(Misc.; 2023 Key Tax Numbers)**

Comment: Since a lot of our clients phase out of making deductible IRA, or direct Roth IRA, contributions, it is important to remember that "backdoor Roth IRA contributions" are still permitted. But make sure that there is no other balance in a deductible IRA (including a SIMPLE IRA). Using **Form 8606**, make a nondeductible contribution to a regular IRA and then immediately (i.e., before there are any earning on this initial amount) convert this IRA balance over to a Roth IRA.

Reminders for 2023 Tax Year

Form 8960 - 3.8% Medicare Surtax on Net Investment Income: The 3.8% surtax on net investment income continues to apply for single taxpayers (including heads of households) with modified AGI over $200,000 and $250,000 for jointly filed returns.

Comment: Since the **Code §1411** 3.8% Medicare surtax came into the law in the 2014 tax year, there has been no inflation adjustment to either the $200,000 or $250,000 thresholds.

Form 8959 - .9% Medicare Surtax on Earned Income: The .9% surtax on earned income continues to apply for single taxpayers (including heads of households) with modified AGI over $200,000 and $250,000 for jointly filed returns.

Comment: No inflation adjustment to these thresholds as well.

Foreign Income Exclusion: U.S. taxpayers working abroad will have a larger income exclusion (i.e., as shown on **Form 2555**) with up to $120,000 being excluded on foreign earned income.

Comment: There are no changes to either **Form 2555** (i.e., foreign earned income exclusion) or **Form 1116** (i.e., calculation of foreign tax credit) for the 2023 tax year.

Health Savings Accounts: The annual cap on deductible contributions to HSAs increases in 2023 to $3,850 for self-only coverage and $7,750 for family coverage. Individuals born before 1969 can make an additional "catch-up contribution" amount of $1,000 more. Qualifying insurance policies (i.e., HDHP) must limit out-of-pocket costs to $15,000 for family health plans and $7,500 for people with individual coverage. Minimum policy deductibles remain $3,000 for families and $1,500 for individuals.

Comment: An overlooked fact is that the initial establishment of a health savings account can be done with a nontaxable transfer from a taxpayer's IRA.

- Unified Credit Equivalent: Estates of decedents who die during 2023 have a basic exclusion amount of $12,920,000, up from a total of $12,060,000 for estates of decedents who died in 2022.

- Annual Gift Tax Exclusion: The annual exclusion for gifts increases to $17,000 for calendar year 2023, up from $16000 for calendar year 2022

Employee Fringe Benefits: The limit on employer-provided tax-free parking goes up to $300 a month. The exclusion for mass transit passes and commuter vans matches that amount. Employees covered by health flexible savings accounts can defer up to $3,050. But contributions to dependent care FSAs under **Code §129** by working parents decrease dramatically. In 2021, working parents could put aside up to $10,500. For 2023, it will be limited to $5,000 (i.e., and this is for two or more qualifying children; $2,500 for just one child).

Nanny Tax: The nanny employment tax threshold (i.e., as shown on **Schedule H**) is $2,600 for

2023, a $200 increase from 2022.

50% Deduction for Restaurant Meals: Businesses will once again only be able to deduct 50% of restaurant meals, provided the cost is *not* lavish and the taxpayer (or, their representative) is present. The 100% temporary relief for this deduction only applied for business meals in 2021 and 2022.

Standard Mileage Rates: The 2022 standard mileage rate for business driving increases to 58.5¢ a mile. The mileage allowance for medical travel and military moves increases to 18¢ a mile in 2022. But the charitable driving rate stays put at 14¢ per mile since it is fixed by law.

> **Comment:** The IRS just announced (i.e., **IRS Ann. 2022-13**) that the standard mileage rate will be increasing to 62.5¢/mile starting 7/1/2022.

Sec. 179 Immediate Expensing: $1,160,000 of qualified assets can be expensed in 2023 with this amount phasing out dollar for dollar once more than $2,890,000 of such assets are put into service during 2023.

Cash Method of Accounting: More businesses will be allowed to use the cash method of accounting. For taxable years beginning in 2023, C corporations with average annual gross receipts of $29 million or less over the previous three years can use the cash method (i.e., "qualified small businesses"). This threshold also applies to partnerships and LLCs that have C corporations as owners. **(Misc.; Key 2023 Tax Amounts)**

☞**Key Inflation-Adjusted Numbers for 2024 Tax Year**

The income tax brackets, standard deduction amounts, and many other tax items are adjusted annually for cost-of-living increases and reflect the "average chained Consumer Price Index (CPI)" for all-urban customers (C-CPI-U) for the 12-month period ending the previous August 31st. Based on the August 2023 CPI summary released by the Labor Department and using the chained CPI for August 2023 (and the preceding 11 months), the key 2024 indexed amounts are listed below.

> **Comment:** To stay current on not only these updated numbers, but also a tremendous amount of other key IRS information, consider signing up for "**e-Subscriptions**" on the IRS website. Also, where the 2024 tax numbers were *not* yet available for a particular tax provision, the current 2023 tax amounts are listed below.

Tax Rate Schedules:

For Married Individuals Filing Joint Returns and Surviving Spouses:

If taxable income is not over $23,200; the tax is 10% of taxable income

If taxable income is over $23,200 but not over $94,300; the tax is $2,320.00 plus 12% of the amount over $23,200

If taxable income is over $94,300 but not over $201,050; the tax is $10,852.00 plus 22% of the amount over $94,300

If taxable income is over $201,050 but not over $383,900; the tax is $34,337.00 plus 24% of the amount over $201,050

If taxable income is over $383,900 but not over $487,450; the tax is $78,221.00 plus 32% of the amount over $383,900

If taxable income is over $487,450 but not over $731,200; the tax is $111,357.00 plus 35% of the amount over $487,450

If taxable income is over $731,200; the tax is $196,669.50 plus 37% of the amount over $731,200

For Single Individuals (Other than Heads of Households and Surviving Spouses):

If taxable income is not over $11,600; the tax is 10% of taxable income

If taxable income is over $11,600 but not over $47,150; the tax is $1,160.00 plus 12% of the amount over $11,600

If taxable income is over $47,150 but not over $100,525; the tax is $5,426.00 plus 22% of the amount over $47,150

If taxable income is over $100,525 but not over $191,950; the tax is $17,168.50 plus 24% of the amount over $100,525

If taxable income is over $191,950 but not over $243,725; the tax is $39,110.50 plus 32% of the amount over $191,950

If taxable income is over $243,725 but not over $609,350; the tax is $55,678.50 plus 35% of the amount over $243,725

If taxable income is over $609,350; the tax is $183,647.25 plus 37% of the amount over $609,350

> **Comment:** There continues to be a significant "marriage penalty" especially in the higher marginal brackets. For instance, the 37% tax bracket does not commence until $609,350 for unmarried taxpayers, whereas it starts at just $731,200 for MFJ filers. Why isn't this amount twice that available for single filers?

For Heads of Household:

If taxable income is not over $16,550: the tax is 10% of taxable income

If taxable income is over $16,550 but not over $63,100; the tax is $1,655.00 plus 12% of the excess over $16,550

If taxable income is over $63,100 but not over $100,500; the tax is $7,241.00 plus 22% of the excess over $63,100

If taxable income is over $100,500 but not over $191,950; the tax is $15,469.00 plus 24% of the excess over $100,500

If taxable income is over $191,950 but not over $243,700; the tax is $37,417.00 plus 32% of the excess over $191,950

If taxable income is over $243,700 but not over $609,350; the tax is $53,977.00 plus 35% of the excess over $243,700

If taxable income is over $609,350; the tax is $181,954.50 plus 37% of the excess over $609,350

For Married Individuals Filing Separate Returns:

If taxable income is not over $11,600; the tax is 10% of taxable income

If taxable income is over $11,600 but not over $47,150 the tax is $1,160.00 plus 12% of the excess over $11,600

If taxable income is over $47,150 but not over $100,525; the tax is $5,426.00 plus 22% of the excess over $47,150

If taxable income is over $100,525 but not over $191,950; the tax is $17,168.50 plus 24% of the excess over $100,525

If taxable income is over $191,950 but not over $243,725; the tax is $39,110.50 plus 32% of the excess over $191,950

If taxable income is over $243,725 but not over $365,600; the tax is $55,678.50 plus 35% of the excess over $243,725

If taxable income is over $365,600; the tax is $98,334.75 plus 37% of the excess over $365,600

For Estates and Trusts:

If taxable income is less than $3,100; the tax is 10% of taxable income

If taxable income is over $3,100 but not over $11,150; the tax is $310.00 plus 24% of the excess over $3,100

If taxable income is over $11,150 but not over $15,200; the tax is $2,242.00 plus 35% of the excess over $11,150

If taxable income is over $15,200; the tax is $3,659.50, plus 37% of the excess over $15,200

> **Comment:** With the highest marginal rate of 37% being applied at just $15,200 of taxable income for a trust it is advisable to get this income out to the beneficiaries (even if it is subject to "kiddie tax") to garner as much of an offsetting "distribution deduction" on **Form 1041** as possible.

Standard Deductions:

The basic standard deduction for 2024 will be:

Joint return or surviving spouse $29,200 ($27,700 for 2023)

Single (not head of household $14,600 ($13,850 for 2023) or surviving spouse)

Head of household $21,900 ($20,800 for 2023)

Married filing separate returns $14,600 ($13,850 for 2023)

> **Comment:** With the dramatic increase in the rate of inflation, you can now see how it impacts the annual increases to these key tax numbers. Also, for those taxpayers 65 and older, these amounts are even higher. For example, MFJ filers would be receiving a standard deduction of $32,200 (i.e., $29,200 + $3,000) and if their home mortgage is paid off, along with the $10,000 SALT cap, they will most probably *not* be itemizing their deductions on **Schedule A**. In fact, it is estimated that over 90% of all taxpayers are now using the standard deduction as opposed to itemizing.

Earned Income Tax Credit:

For 2024, the maximum amount of earned income on which the earned income tax credit will be computed is $8,260 for taxpayers with no qualifying children, $12,390 for taxpayers with one qualifying child, and $17,400 for taxpayers with two or more qualifying children.

For 2024, the phaseout of the allowable earned income tax credit will begin at $17,250 for joint filers with no qualifying children ($10,330 for others with no qualifying children), and at $29,640 for joint filers with one or more qualifying children ($22,720 for others with one or more qualifying children).

> **Comment:** Taxpayers are required to use IRS tables to determine the amount of their earned income tax credit. While these tables are based on the inflation-adjusted figures set out above, because the credit under the tables is the same for everyone within a $50 range, there may be slight differences between the credit under the tables and the credit the taxpayer would determine using those inflation-adjusted figures.

> **Comment:** The amount of “disqualified income” (i.e., generally investment income) a taxpayer may have before losing the entire earned income tax credit is $11,600 for 2024.

Child Tax Credit:

The child credit is refundable, subject to the limit described below, to the extent of the *greater* of:

- 15% of earned income above $2,500, or

- For taxpayers with three or more qualifying children, the excess of the taxpayer’s social security taxes for the tax year over his or her earned income tax credit for the year. (**Code §24(d)**)

> **Comment:** The *refundable* portion of the child tax credit for any qualifying child cannot exceed $1,700 for 2024.

Capital Gains and Qualified Dividend Brackets:

For 2024, the capital gains tax rates will be as follows:

The 0% capital gains rate applies to adjusted net capital gain of up to:

- Joint returns and surviving spouses - $94,050 ($89,250 in 2023)

- Single filers and married taxpayers filing separately - $47,025 ($44,625 in 2023)

- Heads of household - $63,000 ($59,750 in 2023)

- Estates and trusts - $3,150 ($3,000 in 2023)

> **Comment:** Taxpayers finding themselves with an unusually low amount of taxable income (e.g., due to an NOL) and, thus in this "zero percent tax bracket" would be advised to sell any appreciated assets such as stocks and then repurchase them at a stepped-up FMV basis since the "wash sale rules" only apply to loss situations. For MFJ filers this step-up could amount to $94,050 in 2024.

The 15% capital gains tax rate applies to adjusted net capital gain over the amount subject to the 0% rate, and up to:

- Joint returns and surviving spouses - $583,750 ($553,850 in 2023)

- Married taxpayers filing separately - $291,875 ($276,925 in 2023)

- Heads of household - $551,350 ($523,050 in 2023)

- Single filers - $518,900 ($492,300 in 2023)

- Estates and trusts - $15,450 ($14,650 in 2023)

> **Comment:** Again, we see the "marriage penalty" where an unmarried individual would not face a 20% marginal tax rate on LTCGs or qualified dividends until reaching $518,900 of taxable income, whereas MFJ filers see this rate apply at $583,750. So, why isn't this threshold double that for single taxpayers?

The 20% capital gains tax rate applies to adjusted net capital gain over the above 15% maximum amounts.

Phaseout Thresholds for Sec. 199A Qualified Business Income Deduction:

For 2024, taxpayers with taxable income above $191,900 for single and head of household returns, $383,850 for joint filers, and $191,925 for married filing separate returns are subject to certain limitations on the Code Sec. 199A deduction. The 2023 amounts were $182,100, $364,200, and $182,100.

> **Comment:** These phaseout rules come into play when the taxpayer's taxable income *before* the Sec. 199A deduction is taken into account exceeds the end of the 24% tax bracket for their respective filing status.

> **Comment:** There is no change to the $100,000 phaseout range for MFJ filers, or the $50,000 phaseout range for other taxpayers.

MAGI Limits for Making Deductible Contributions by Active Plan Participants to Traditional IRAs:

In general, an individual who is *not* an "active participant" in certain employer-sponsored retirement plans (e.g., 401(k) or 403(b) plans), and whose spouse is *not* an active participant, may make an annual deductible cash contribution to an IRA up to the *lesser* of: (1) an inflation-adjusted statutory dollar limit, or (2) 100% of the compensation that's includible in his or her gross income for that year. For 2024, the "statutory dollar limit" is $7,000 ($6,500 in 2023), plus an additional $1,000 catch-up for those age 50 or older ($1,000 in 2023).

If the individual (or, their spouse) is an "active plan participant," the deduction phases out over a specified dollar range of MAGI. For taxpayers filing joint returns, the otherwise allowable deductible contribution will be phased out ratably for 2024 for MAGI between $123,000 and $143,000 ($116,000 and $136,000 in 2023).

For 2024, for single taxpayers and heads of household, the otherwise allowable deductible contribution will be phased out ratably for MAGI between $77,000 and $87,000 ($73,000 and $83,000 in 2023). For married taxpayers filing separate returns, the otherwise allowable deductible contribution will be phased out ratably for MAGI between $0 and $10,000 ($0 and $10,000 in 2023).

For a married taxpayer who is *not* an "active plan participant" but whose spouse is such a participant, the otherwise allowable deductible contribution will be phased out ratably for 2024for MAGI between $230,000 and $240,000 ($218,000 and $228,000 in 2023).

MAGI limits for making contributions to Roth IRAs. Individuals may make nondeductible (i.e., after-tax) contributions to a Roth IRA, subject to the overall limit on IRA contributions.

The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with MAGI over certain levels for the tax year. For taxpayers filing joint returns, the otherwise allowable contributions to a Roth IRA will be phased out ratably for 2024 for MAGI between $230,000 and $240,000 ($218,000 and $228,000 in 2023).

For single taxpayers and heads of household, it will be phased out ratably for MAGI between $146,000 and $161,000 ($138,000 and $153,000 in 2023). For married taxpayers filing separate returns, the otherwise allowable contribution will continue to be phased out ratably for MAGI between $0 and $10,000 ($0 and $10,000 in 2023).

> **Comment:** As of this point in time, "back-door Roth IRA conversions" are still permitted. As a result, funds can be essentially contributed to a Roth IRA regardless of one's MAGI.

Sec. 179 Immediate Expensing:

The amount that may be expensed under **Code §179** for 2024 will be $1,220,000 ($1,160,000 for 2023). For 2024, the expensing limit will be reduced when more than $3,050,000 of expensing-eligible property is placed in service ($2,890,000 for 2023).

> **Comment:** There is no point for taking such rapid write-offs using either Sec. 179 or bonus depreciation where losses are going to be created with the owners having insufficient at-risk basis or the PAL rules otherwise being applied. And, now, we also have the **Code §4619(l)** "excess loss limitation" coming into play. The bottom line is that the asset's basis has to be reduced immediately while it might be years before the owners are able to use the corresponding write-off.

Foreign Earned Income and Housing Cost Exclusion:

The foreign earned income exclusion amount will be $126,500 in 2024 ($120,000 in 2023). The foreign housing cost exclusion will be $17,710 in 2024 (up from $16,800 in 2023). **(Misc.; 2024 Key Tax Numbers)**

☞**Passport Renewal Denied Due to Outstanding Tax Liabilities**

For those individuals with delinquent tax liabilities outstanding of $59,000 or more and for whom a tax lien or levy has been issued, they will deny the privilege of renewing their expired passports. The IRS supplies the names of the delinquent taxpayers to the State Department, while also notifying the individuals involved that this is happening. IRS **Notice CP508C** is also sent listing the taxes owed and that passport renewal will be denied. Finally, the Tax Court is upholding these denials as being proper in two recent decisions. **(Misc.; Notice CP508C)**

☞**IRS Website Provides Helpful Information for Military Personnel (FS-2023-14)**

The IRS is encouraging members of the military and their families to learn more about the special tax benefits available to them. This website is also a good source of information and planning tips for tax professionals preparing such returns. **IRS Pub. 3, Armed Forces' Tax Guide**, is filled with valuable information and tips designed to help service members and their families take advantage of all the tax benefits allowed by law. Several of these key benefits include:

- **Combat Pay Exclusion:** Combat pay is partially or fully tax-free. Service members serving in support of a combat zone or in a "qualified hazardous duty area" may also qualify for this exclusion. In addition, U.S. citizens or resident aliens, such as spouses, who worked as contractors or employees of contractors supporting the U.S. armed forces in designated combat zones, may qualify for the foreign earned income exclusion.

- **Filing Deadlines:** Members of the military, such as those who serve in a combat zone or are serving in "contingency operations" outside the United States, can postpone most tax deadlines. Those who qualify can get automatic extensions of time to file and pay their taxes.

- **EITC:** The Earned Income Tax Credit is worth up to $6,935 for tax year 2022. Low- and moderate-income service members who receive nontaxable combat pay can use a "special computation method" that may boost the EITC, resulting in less tax owed or receiving a larger refund.

- **Child Care Costs:** Dependent care assistance programs for military personnel are excludible benefits and *not* included in the military member's income.

- **Moving Expenses:** Members of the armed forces on active duty may be eligible to deduct unreimbursed moving expenses if their move was due to a military order and permanent change of station. Also, allowances paid to move members of the U.S. armed forces for a permanent change of station are *not* taxable. **(Misc.; Military)**

☞**IRS Outlines Special Tax Benefits for Members of Military and Their Families (Tax Tip 2020-93)**

Members of the military may qualify for **special tax benefits**. For instance, they do *not* have to pay taxes on some types of income. Special rules could lower the tax they owe or allow them more time to file and pay their federal taxes.

> **Comment:** Especially if we are *not* preparing returns with potential military related tax issues on a regular basis, taking a look at **IRS Pub. 3, "Armed Forces Tax Guide"** or this "tax tip" would be heavily recommended.

Here are some of these special tax benefits afforded for members of our armed forces:

- **Combat pay exclusion**: If someone serves in a combat zone, part or all of their pay is tax-free. This also applies to people working in an area outside a combat zone when the Department of Defense certifies that area is in direct support of military operations in a combat zone. There are limits to this exclusion for commissioned officers.

- **Other nontaxable benefits:** Base allowance for housing, base allowance for subsistence and uniform allowances are among several government pay items excluded from gross income.

- **Moving expenses:** Some non-reimbursed moving expenses may be tax deductible. To deduct these expenses, the taxpayer must be a member of the Armed Forces on active duty and their move must be due to a military order or result of a permanent change of station.

- **Deadline extensions**: Some members of the military (e.g., such as those who serve overseas) can postpone most tax deadlines. Those who qualify can get automatic extensions of time to file and pay their taxes.

- **Earned income tax credit**: Special rules allow military members who get nontaxable combat pay to choose to include it in their taxable income. One reason they might do this is to increase the amount of their earned income tax credit. People who qualify for this credit could owe less tax or even get a larger refund.

- **Joint return signatures:** Both spouses must normally sign a joint income tax return. However, if military service prevents that from happening, **one spouse** may be able to sign for the other or get a power of attorney. Service members may want to consult with their installation's legal office to see if a **power of attorney** is right for them.

- **Reserve and National Guard travel:** Members of a reserve component of the Armed Forces may be able to deduct their unreimbursed travel expenses on their return. In order to do so, they must travel more than 100 miles away from home in connection with their performance of services as a member of the reserves.

- **ROTC allowances**: Some amounts paid to ROTC students in advanced training are *not* taxable. However, active duty ROTC pay is taxable. This includes things like pay for summer advanced camp. **(Misc.; Military)**

Code §1 - Marginal Tax Rates:

☞**Eligibility for 0% Marginal Tax Rate on LTCGs and Qualified Dividends**

In order to determine if a taxpayer is eligible for the 0% marginal tax rate on long-term capital gains and qualified dividends, one must look at their level of taxable income *before* including these two sources of income. If total taxable income (including LTCGs or qualified dividends) does *not* exceed $44,625 on individual returns, $59,750 for heads of household and $89,250 for MFJ filers, then their qualified dividends and LTCGs are taxed at a 0% federal income tax rate until they exceed these respective threshold amounts.

> **Comment:** Just as you do not look to where the 37% marginal tax rate commences to determine whether the 20% LTCG rate applies, the same is true for the 0% special rate. As mentioned previously, you now solely looked to specific amounts that the IRS has issued for the current tax year.

Here are three illustrations to highlight these rules. Assume that in the following examples, a married couple has $10,000 of qualified dividends and long-term gains.

- In the first example, the couple has $65,000 of total taxable income which means that the *entire* $10,000 of gains and dividends is taxed at the 0% rate.

- If instead the couple has total taxable income of $94,250, $5,000 (i.e., $94,250 - $89,250) is taxed at 15% while the other $5,000 receives the favorable 0% marginal tax rate.

- Finally, if the couple has $99,250 of total taxable income, the 0% marginal tax rate does *not* apply and *entire* $10,000 of LTCGs and qualified dividends is taxed at 15%. **(Code §1; Marginal Tax Rates)**

> **Comment:** Even if the taxpayer is lucky enough to receive the 0% marginal tax rate on such income, LTCGs and qualified dividends still serve to increase their AGI (e.g., in determining taxation of SSBs or deduction for medial expenses on **Schedule A**, along with determining various phaseout amounts). Furthermore, even though these source of income might *not* be taxed at the federal level, but may still be taxed on a state or local level as ordinary income.

Code §24 - Child Tax Credit:

☞Due Diligence Requirement for Claiming Child Tax Credit

Tax preparers with clients claiming certain benefits on their 2021 return should be aware of their "due diligence requirements" including those for advance child tax credit (CTC) payments in order to avoid compliance letters from the IRS, along with potential penalties. Pursuant to **Reg §1.6695-2**, paid tax return preparers must, for each return:

- Complete and submit **Form 8867, Paid Preparer's Due Diligence Checklist**;

- Compute applicable credits based on the facts;

- Not have knowledge that any aspect of the return is incorrect, and

- Retain records for three years (i.e., **Form 8867**, copies of each completed worksheet, how and when information was obtained)

"Due diligence tax benefits" include the earned income tax credit, CTC, credit for other dependents, American opportunity tax credit, and head of household filing status. This would include the advance payments of the CTC, which eligible taxpayers received in amounts equal to 50% of their expected annual CTC payment spread out over monthly installments. For clients who received such payments in 2021, the **Form 8867** due diligence requirement "may apply through the 2021 even if no CTC amount is claimed on the **Form 1040** itself," said Yvette Davis, an IRS representative at a recent webinar hosted by the IRS entitled **"Keys to Mastering Due Diligence Requirements and What to Expect During a Due Diligence Audit."**

Preparers who fail to meet their due diligence requirements may be assessed a $500 penalty under **Code §6695**, adjusted for inflation, for each failure. The per failure penalty for 2023 has been adjusted for inflation and is $560. If the preparer has a "due diligence failure" for four benefits, for example, the total penalty for that return would be $2180.

Penalties can be avoided by preparers making "reasonable inquiries" as they arise when completing the return, and properly recording those inquires, the taxpayer's responses, and any supporting documentation. Due diligence is achieved if such inquiries are made and resolved before the return is filed. According to IRS Senior Program Analyst Courtney King, preparers should know how to ask the "right questions" using their knowledge of the law, experience, and personal interview process. "[I]f the information your client is giving you appears to be incorrect, inconsistent, or incomplete, you must continue to explore by asking additional questions until you're comfortable with the information they provide," King said at the webinar.

If a preparer is "uncomfortable asking for sensitive information to determine credit eligibility, related IRS forms can be used to guide taxpayers through the requirements." While due diligence rules generally do *not* require prepares to request specific documentation, preparers should keep a copy of any document that was relied upon to complete the return as a "simple rule," King said.

The IRS may send a **Letter 5025** or **4858** to a preparer whom the IRS suspects did *not* meet due diligence requirements. The letters include compliance instructions and a penalty warning. The IRS may send a **Letter 5364** if a return is missing **Form 8867**. If a preparer agrees to an assessed penalty, **Form 5816, Report of Tax Return Preparer Penalty Case**, should be signed and submitted. A preparer can challenge a penalty with the IRS Appeals Office. The IRS recommends that preparers refer to its "due diligence toolkit for training modules, webinar recordings, and other resources." **(Misc.; Due Diligence)**

Code §25A - Educational Tax Credits:

☞Fact Sheet Highlights Optimum Use of Scholarships and Education Credits

The treasury is concerned that students who receive scholarships, such as Pell Grants, and their parents (if the student is a dependent) might be missing out on education-related tax credits, like the American Opportunity Tax Credit because the process for claiming the credits is so complex. The magnitude of the problem appears to be quite significant for the nine million students or so who receive Pell Grants, resulting in hundreds of millions of dollars of unclaimed credits each year. Therefore, the Treasury has provided a **fact sheet** advising students and their families on how to receive the maximum education tax benefits for which they are eligible. **(Code §25A; AOTC)**

> **Comment:** Based on the IRS' Q&As regarding the AOTC, "you are *not* required to claim the credit for a particular year." If your child's college does *not* consider your child to have completed the first four years of college (i.e., post-secondary education) as of the beginning of the tax year in question, you may take the credit, so long as you have *not* claimed either the AOTC or the Hope credit for 4 previous tax years. In other words, even if the child is on-track to to complete their college education in four academic years, the spring semester of their senior year might, in fact, represent the *fifth* tax year on their parents' tax return. Nevertheless, if either credit has *not* been claimed for any of the four previous tax years (e.g., their AGI was too high and the credit would have been phased out), then the AOTC could be claimed for the child's last semester of college.

> **Comment:** If the student is already paying $4,000 or more for "qualified higher educational expenses," then how any monies, such as those from a Pell Grant or scholarship are used, is *not* a factor from a tax standpoint for claiming the AOTC. But, if by chance, some of these expenses are instead paid with these afore-mentioned school loan funds, an election can be made to deem other nonqualifying expenses such as room and board to have been paid with them, thereby leaving what was actually paid with the taxpayer's own funds for the AOTC expense purposes.

Code §30D - Plug-in Electric Vehicle Credit:

☞**Requirements for Claiming Clean Vehicle Energy Credit (IR-2023-160)**
The IRS is reminding consumers considering an automobile purchase to be sure to understand several recent changes to the new **Clean Vehicle Credit** for "qualified plug-in electric drive vehicles." This would include making sure that you are dealing with a "qualified manufacturer" along with various other special tax requirements before any credit can be claimed.

> **Comment:** For vehicles placed in service (i.e., delivered to the customer) beginning in 2024, clients can get the immediate benefit of the credit at the time of purchase for the new clean vehicle credit, previously owned clean vehicle credit, and commercial clean vehicle credit by transferring the credit to the dealer. In other words, this effectively accelerates the benefit of the credit by reducing the purchase price of the vehicle. But dealerships should pre-register with the IRS to become "eligible entities" so that this planning strategy is possible.

Inflation Reduction Act of 2022: The **Inflation Reduction Act of 2022 (IRA)** made several changes to the new Clean Vehicle Credit for "qualified plug-in electric drive motor vehicles," including adding "fuel cell vehicles." The IRA also added a new credit for previously owned (i.e., used) and "commercial clean vehicles." And before taxpayers purchase a clean vehicle they should make sure that the vehicle was made by a "**qualified manufacturer**." Taxpayers must also meet other **requirements** such as the modified adjusted gross income limits.

"Qualified Manufacturer:" To be a "qualified manufacturer," the manufacturer must enter into an approved agreement with the Internal Revenue Service and supply the IRS with valid vehicle identification numbers (VINs) that can later be matched at the time of filing to the VIN reported on the taxpayer's return.

Eligible Vehicles: When purchasing a new or used clean vehicle, purchasers should also check to see if the **make and model** are eligible for the credit. In addition, for a new or used clean vehicle to be eligible for a Clean Vehicle Credit, the seller must provide the buyer with a "seller report" verifying that the vehicle purchased will qualify for the credit, which will include the make, model, and VIN.

Nonrefundable Credit: The clean vehicles tax credits are *non-refundable* tax credits meaning that these credits cannot be used to increase the taxpayer's tax refund or to create a tax refund. These credits will only reduce the amount of tax they owe.

> **Comment:** For more information on these credits and other clean energy credits related to the **Inflation Reduction Act**, check **Credits and Deductions Under the Inflation Reduction Act of 2022**. Also, **FAQs About the New, Previously-Owned and Qualified Commercial Clean Vehicles Credit** and **About Form 8936, Qualified Plug-In Electric Drive Motor Vehicle Credit** are available.

> **Comment:** As far as the credit available for clean vehicles purchased in 2022 or before, refer to the following IRS **website**. There is also a **video** which summarizes these rules. **(Code §30D; Plug-in Vehicle Credit)**

Code §32 - Earned Income Tax Credit:

☞**IRS Continues to Pay Out Billions in Erroneous EITCs**

For the 2022 fiscal year, it is estimated that the IRS paid out $18.2 billion in improper earned income tax credits. This represents a 31.6% improper payment rate. The Service stated that their a number of factors behind this situation. First, the IRS lacks sufficient "third-party documents" (i.e., a "paper trail") to adequately verify information shown on filed tax returns. Second, the EITC eligibility rules are "overly complex." Third, many EITC returns are done by unenrolled preparers (i.e., non-CPAs, EAs or attorneys) who are inadequately prepared to deal with more complicated tax issues. As a result, these unenrolled preparers have a higher rate of EITC errors when compared with other tax professionals. Nevertheless, latest statistics indicate that the IRS is gradually correctly the situation with the 2022 improper EITC payment figure being a bit lower than 2021's $18.97 billion amount. With regard to other refundable credits, approximately $7.8 billion was improperly paid out in 2022. This amount included refundable child credits, American Opportunity credits and health premium credits. **(Misc.; Tax Credits)**

☞**EITC Can Be Disallowed for Two Years Even for Partial Denial in Previous Year (CCA 201931008)**
If a taxpayer's Earned Income Tax Credit (EITC) claim is denied because of "reckless or intentional disregard of rules and regulations," they are *not* permitted to claim the credit for the following two years. (Cf. **Code §32(k)(1)(B)(ii)**) In this recent Chief Counsel Advice (CCA), the taxpayer claimed the EITC based on three children. However, the IRS disallowed the credit for one of the children. Despite that, the taxpayer continued to claim the child for the following years. The IRS concluded that the two-year ban applied in this case even though the taxpayer was otherwise entitled to the EITC for her other two children. According to the agency, **Code §32(k)(1)(B)(ii)** does *not* prohibit imposition of the ban for *partial* disallowances, assuming a final determination is made that the taxpayer's claim was due to "reckless or intentional disregard of rules and regulations." **(Code §32; EITC)**

☞**Tax Preparers with Returns Listing Questionable Refundable Credit Claims to Receive IRS Letter 5025**
According to the IRS, tax preparers who have submitted returns with "questionable claims" for the Earned Income Tax Credit (EITC), the Child Tax Credit Tax Credit/Additional Child Tax Credit (CTC/ACTC) and the American Opportunity Tax Credit will soon begin receiving **Letter 5025**. The intent of the letter is to raise awareness around questionable tax returns and assist preparers in meeting their due diligence requirements. **(Misc.; IRS Letter 5025)**

> **Comment:** For more information on "due diligence requirements," the IRS suggests that tax return preparers visit the **Tax Preparer Toolkit**. And, of course, **Form 8867** must be included in the client's tax return when any one of these credits is being claimed.

☞**EITC Overpayments Continuing to Come Under Scrutiny (GAO-18-377)**
A Government Accountability Office (GAO) report included the earned income tax credit (EITC) among the 10 programs it reviewed for "improper payment estimation methodologies." EITC program outlays in fiscal year 2017 were just under $68 billion. But, the estimate of improper payments for the program was $16.2 billion (i.e., about 24%). According to the report, executive branch agencies "must take various steps regarding improper payments." These steps include: reviewing all programs and activities and identifying those that may be susceptible to significant improper payments; developing improper payment estimates for those programs and activities that the agency identified as being susceptible to significant improper payments; analyzing the primary causes of improper payments and developing corrective actions to reduce them for those programs and activities that the agency identified as being susceptible to significant improper payments; and reporting on the results of addressing the foregoing requirements.

GAO noted that IRS auditors "examine whether the taxpayer properly reported income and whether the taxpayer meets eligibility criteria, including income and qualifying child requirements, and they examine, among other things, whether the taxpayer is subject to a disallowance period on receiving the EITC."

GAO concluded that although Office of Management and Budget guidance requires the IRS to include all improper payments in its estimates, regardless of whether they have been or are being recovered, the IRS does *not* adhere to this policy change. "By not updating its guidance and continuing to remove EITC overpayments that may be subsequently recovered, the IRS is understating its improper payment estimate and potentially limits its ability to address these types of improper payments before they occur," GAO said. "Administering EITC is a significant challenge for the IRS due to its nature and the lack of information necessary for complete verification of taxpayer eligibility and claims at the time a return is filed," said Acting IRS Commissioner David Kautter in a response to the report. "We also lack certain third-party information that could be used to verify eligibility for EITC since the information needed may *not* be available when returns are process, may be unreliable or may not exist," he said. "We believe that additional third-party reporting requirements and correctible error authority are essential to reducing overclaims," Kautter added. **(Code §32; EITC)**

Code §36B - Premium Tax Credit:

☞**Taxpayers Erroneously Claiming PTCs on Form 8962 (*Sek*, TC Memo. 2022-87 (9/22/2022))**

Individuals who claim health care premium tax credits on **Form 8962** are receiving special attention from IRS auditors. The premium tax credit (PTC) is available for eligible individuals with certain incomes (i.e., approximately those with modified adjusted gross incomes below 400% of the federal poverty level) who buy health insurance through one of the exchanges (e.g. **healthcare.gov**) and qualify for these subsidies. However, individuals who are eligible for Medicare or other federal insurance do *not* qualify. Nor do individuals who can get “affordable health coverage” through their employer.

This Tax Court case is an example where a taxpayer claimed erroneous premium credits. After he lost his job, he enrolled in COBRA continuation health coverage for himself and his family through his employer. He later terminated that insurance and purchased coverage through an exchange. He was entitled to the premium credit for a portion of his cost of coverage from the exchange. But his cost of COBRA coverage from his former employer’s health plan is *not* eligible for the credit. **(Code §36B; PTC)**

☞**Service Rejecting Returns for Missing Premium Tax Credit Form 8962**

The IRS recently posted an update on its “**filing season alerts page**” that addresses rejected e-filed returns that are missing **Form 8962, Premium Tax Credit**. **Form 8962** is used to reconcile the receipt of advance payments of the premium tax credit (APTC) to the amount that the taxpayer is ultimately entitled to receive.

New IRS Policy: Before 2021, the IRS did *not* reject tax returns that were filed without a required **Form 8962**. Instead, after receiving the return, the IRS would alert the filer, requesting the form or a written explanation of why the form was *not* attached to the return.

Comment: Keep in mind that the IRS receives notice of any instance where the taxpayer has received an advanced premium credit from ***healthcare.gov***.

Resubmitting Return Electronically after IRS Rejection: The rejected return may be resubmitted electronically once the missing **Form 8962** is completed and included in the return or a written explanation of why **Form 8962** was originally absent is attached to the return. **(Code §36; Premium Tax Credit)**

Comment: For more information, see “How to correct an electronically filed return rejected for a missing **Form 8962**.” Of course, resolving the missing **Form 8962** issue at the time of filing, instead of through correspondence, will avoid processing delays that occur when the IRS needs to correspond with the taxpayer regarding the missing form.

☞**Reporting Changes in Financial Status to Health Insurance Exchanges (HCTT-2014-07)**

The IRS issued a reminder to enrollees in health insurance coverage through the Health Insurance Marketplace that it is still possible to report changes in circumstance that may affect their premium tax credits. This advice was issued as **"Health Care Tax Tip-2014-22."** Among the changes in circumstances that should be reported are the following: an increase or decrease in income, marriage or divorce, and the birth or adoption of a child. **(Misc.; Health Care Act)**

> **Comment:** For changes such as a dramatic increase in income (and, this would include simply getting married to someone with significant income), this should be reported immediately to the health care exchange so that an adjustment can be made in the case of any advance premium tax credits.

☞**Taxpayer Ineligible for Premium Tax Credit after Marriage (*Fisher*, TC Memo 2019-44 (4/30/2019))**

In December 2014, the taxpayer purchased a health insurance policy through the government's Health Exchange and determined that she was eligible for an advance Premium Tax Credit (PTC). As a result, beginning 1/1/15, the Exchange applied the advance PTC to her monthly insurance premium. In November 2015, the taxpayer got married. She filed a joint return with her spouse for 2015, which reflected an AGI of $113,975. The IRS issued a notice of deficiency, claiming that the taxpayer's income exceeded 400% of the amount of the federal poverty line. The taxpayer argued that she should *not* be required to repay the entire amount of the advance PTC because she was eligible for the credit at least for the time period *before* she got married. The Tax Court rejected this argument, holding that "it could *not* ignore the plain language of the statute to achieve what may be an equitable end." As a result, the taxpayer was required to pay back the PTC (i.e., as calculated on **Form 8962**). **(Code §36; Premium Tax Credit)**

> **Comment:** This case confirms that the "400% x FPL test" is applied on a taxpayer's total annual income, determined as of the last day of the tax year. What should have occurred here is that the taxpayer needs to contact the Exchange and have them cease making any premium payment on her behalf once she realizes that her anticipated annual income no longer qualifies her for the APTC. Furthermore, she will still be responsible for repayment of the credit assistance already received when she file her **Form 1040** and includes the **Form 8962** calculation of the overpayment.

Social Security Benefits Considered for Premium Tax Credit (*Levon Johnson*, 152 TC No. 6 (3/11/2019))

In 2014, the taxpayer enrolled in an ACA health insurance marketplace plan, and received monthly advanced Premium Tax Credit (PTC) payments under **Code §36B** to cover a portion of the cost. Also in 2014, the taxpayer received social security benefits in a lump sum, relating to both 2013 and 2014. The IRS assessed a deficiency of excess advanced PTC payments (i.e., on **Form 8962**), determining the social security benefits put the taxpayer over the income limit to qualify for the PTC under **Code §36B(c)(1)**. The taxpayer then amended the 2014 tax return to make a "**Section 86(e)** election." This election limits the amount of prior-year social security benefits included in gross income in a subsequent year to *not* exceed the increase in gross income that would have resulted if the amount had instead been received in the prior year. The amended return reported a reduced deficiency amount from the election. However, the Tax Court ruled that, for purposes of the PTC, the *total amount* of social security benefits received in a tax year is included in gross income to determine PTC eligibility, regardless of a "Section 86(e) election." **(Code §36B; APTC)**

☞**Health Care Premium Tax Credit Subject to Minimum Income Levels (*Gartlan*, TC Summ. Op. 2018-42 (9/11/2018))**

If a taxpayer has income that is *below 100% of the federal poverty level* (FPL), they might be precluded from claiming the health care premium tax credit (i.e., on **Form 8962**) even though they are paying for their health care through the government's marketplace (i.e., on **healthcare.gov**). To claim this credit, taxpayers are required to have household incomes ranging *from 100% to 400%* of the federal poverty guidelines. In this instance, the taxpayer reported *negative* adjusted gross income, while also attempting to claim a $3,156 premium tax credit. But, given the fact that his AGI was obviously below the eligible poverty level guideline for the year at issue, the Tax Court disallowed the credit in full. **(Code §36B; Premium Tax Credit)**

> **Comment:** Keep in mind that individuals otherwise eligible for Medicare, Medicaid, Tri-Care or other federal insurance are *not* permitted to claim this credit. Likewise, employees who are able to get affordable health coverage through their employers are barred as well. The bottom line is that they are already receiving either government or employer provided assistance in securing adequate health insurance. So, the IRS is *not* going to allow them to also simultaneously claim a premium tax credit on **Form 8962**.

Code §45L - Energy Credit for Builders:

☞**Tax Credit Requirements for Builders of New Energy Efficient Homes (Tax Tip 2023-113)**

Eligible contractors who build or substantially reconstruct "qualified new energy efficient homes" may be eligible for a tax credit up to $5,000 per home. The actual amount of the credit depends on the various eligibility requirements such as the type of home, the home's energy efficiency rating and the date when someone buys or leases the home.

Eligibility Requirements: Contractors must meet the following eligibility requirements:

- Construct or substantially reconstruct a "qualified home;"

- Own the home and have a basis in it during construction; and

- Sell or rent it to a person for use as a residence

Qualified Home: To qualify, a home must be:

- A single-family (including manufactured homes) or multi-family home, as defined under certain **Energy Star** program requirements;

- Located in the United States;

- Purchased or rented for use as a residence; and

- Certified to meet applicable energy saving requirements based on home type and acquisition date

Energy Credit Requirements: Requirements and credit amounts for 2023 and after are as follows.

For homes acquired in 2023 through 2032, the credit amount ranges from $500 to $5,000, depending on the standards met, which include:

- Energy Star program requirements;

- Zero energy ready home **program** requirements; and

- Prevailing wage requirements

Requirements and credit amounts *before* 2023 are as follows:

For homes acquired *before* 2023, the credit amount is $1,000 if the 30% standard is met or $2,000 if the 50% standard is met. The standards include:

- For the 50% standard, certifying that the home has an annual level of heating and cooling energy consumption that is at least 50% less energy than a comparable home and gets at least 1/5 of its energy savings from building envelope improvements

- For the 30% standard, certifying that the home has an annual level of hearing and cooling energy consumption that is at least 30% less energy than a comparable home

- Meeting certain federal manufactured home rules

- Meeting certain Energy Star requirements

Claiming Energy Tax Credit: Eligible contractors must meet all of the requirements before claiming the credit. Eligible contractors should review the Instructions for **Form 8908, Energy Efficient Home Credit**, for full details about these requirements. **(Code §45L; Energy Tax Credits)**

> **Comment:** For more detailed information on the tax credit for energy efficient homes, the following sources are available: (1) **Credit for Builders of Energy-Efficient Homes**; (2) **Instructions for Form 8908**; and (3) **Credits and Deductions Under the Inflation Reduction Act of 2022**.

☞**Credit for Builders of New Qualified Energy Efficient Homes (IR-2023-142)**

Builders of new "qualified energy efficient homes" might qualify for an expanded tax credit under **Code §45L**. This would include eligible contractors who "build or substantially reconstruct qualified new energy efficient homes" with the tax credit being up to $5,000 per home. The actual amount of the credit depends on eligibility requirements such as the type of home, the home's energy efficiency and the date when someone buys or leases the home. This credit was expanded as part of the **Inflation Reduction Act of 2022**.

> **Comment:** This credit for the builder would be in addition to whatever tax credit the taxpayer home owner might otherwise be entitled to.

Eligibility for Builders and Homes: To qualify, eligible contractors must construct or substantially reconstruct a new qualified energy efficient home. They also must own the home and have a basis in it during the construction, and they must sell or lease the home to an individual for use as a residence (i.e., it does *not* necessarily have to be the individual's "principal residence"). The homes must also be included in one of the specified categories of single-family (including manufactured) or multi-family homes under Energy Star programs, be located in the United States, and meet applicable energy saving requirements based on home type and acquisition date.

Requirements and Credit Amounts for 2023 Onward: For homes acquired in 2023 through 2032, the credit amount ranges from $500 to $5,000, depending on the standards met, which include:

- Energy Star program requirements

- Zero energy ready home program requirements

- Prevailing wage requirements

Requirements and Credit Amounts Before 2023: For homes acquired *before* 2023, the credit amount is $1,000 or $2,000, depending on the standards met, which include:

- Certifying that the home has an "annual level of heating and cooling energy consumption" that is at least 50% (or, 30% for certain manufactured homes) less than that of a comparable home that meets certain energy standards, with "building envelope component improvements" accounting for at least 1/5 (or, 1/3 for certain manufactured homes) of the reduction

- Meeting certain federal manufactured home rules

- Meeting certain Energy Star requirements

Properly Claiming the Credit: Eligible contractors must meet *all* requirements under **Code §45L** prior to claiming the credit. This guidance can be found in **Notice 2008-35** (and **Notice 2008-36**, for manufactured homes). **Form 8908, Energy Efficient Home Credit**, is used to claim the Section 45L credit. If the source to claim the credit is from a partnership or S corporation, eligible contractors should use **Form 3800, General Business Credit**.

Comment: The IRS is emphasizing that eligible contractors keep meticulous record of all documents required to support a claim for the Section 45L credit. **(Code §45L; Energy Efficient Credits)**

Other resources: The following items provide additional information concerning the Section 45L credit:

- **Credit for Builders of Energy-Efficient Homes**

- **Instructions for Form 8908**

- **Credits and Deductions Under the Inflation Reduction Act of 2022**

Proposed Regs on "Prevailing Wage and Apprenticeship Requirements" for Increased Energy Credit or Deduction Amounts (IR-2023-156)

Proposed regs related to the increased tax credit or deduction amounts for clean energy facilities and projects if taxpayers satisfy certain prevailing wage and registered apprenticeship (PWA) requirements have now been issued.

Generally, these new proposed rules provide guidance on the PWA requirements, enacted as part of the **Inflation Reduction Act**, for "certain green energy facilities or projects."

Background: The **Inflation Reduction Act** provides increased credit or deduction amounts that generally apply for taxpayers who satisfy certain PWA requirements regarding the construction, installation, alteration or repair of a "qualified facility, qualified property, qualified project, qualified equipment" or for certain energy facilities. The "increased credit or deduction amount" is generally equal to the "base amount multiplied by five" if the taxpayer otherwise satisfies the PWA requirements. There are, however, certain limited exceptions where a taxpayer may be eligible for an increased credit amount without satisfying the PWA requirements.

The proposed regulations are intended to provide guidance to taxpayers intending to claim the increased credit or deduction amounts, as well as those intending to transfer increased credit amounts. Additionally, the proposed regulations would provide guidance for taxpayers "that initially fail to satisfy the PWA requirements but seek to cure the failure by complying with certain correction and penalty procedures." Finally, the proposed regulations would provide rules concerning specific PWA recordkeeping and reporting requirements.

> **Comment:** The IRS has also released frequently asked questions (**FAQs**) and **IRS Pub. 5855** which is an overview of the "prevailing wage and apprenticeship requirements and the applicable credits."

> **Comment:** The Treasury and IRS previously provided guidance on the PWA requirements in **IR-2022-208**, and in **Notice 2022-61**.

Code §56 - Minimum Tax Credit:

☞Surviving Spouse Not Permitted to Use Deceased Husband's Minimum Tax Credit from Pre-Marriage Year (*Vichich,* 146 TC No. 12 (4/21/2016))

Where the husband had an minimum tax credit as a result of exercising an incentive stock option in a year before he got divorced from his first wife, married again, and then died before he could fully use the MTC that resulted from that earlier payment of AMT, his surviving wife was *not* permitted to take the credit on her single tax returns for years *after* his death.

> **Comment:** Special attention should be paid to the result in this case. With the proliferation of divorces today and second marriages, any tax attributes brought into these (or, any) marriages can only be used on a future joint tax return to the extent and benefit of the spouse who owns them. For instance, a LTCL is personal to that spouse, even if he or she were to marry someone with an extensive stock portfolio producing significant capital gains. And, with prenuptial agreements being fairly common in second marriages, if none of these assets are *not* held at least jointly, this carryover loss can only be used against capital gains, if any, of that particular spouse. The same is true, for instance, with any tax credits or NOL carryovers. And, even if a stock portfolio, for instance, is put into the joint names of both spouses (i.e., using the unlimited gift tax marital deduction), arguably, any capital loss carryover could only be used against *one-half* of any subsequent capital gains.

> **Comment:** The same is true in cases where a spouse with a capital loss carryover or NOL *dies* (instead of getting married, or re-married). Any tax attributes are personal to the deceased spouse's investment portfolio (i.e., to the extent that the stocks sold producing the capital loss were held *solely* in their name), or to an NOL derived from a business (e.g., Schedule C or F) run solely by the decedent. Even where the stocks or business were instead held jointly, would that mean only "half" of the tax attribute would carryover and be available in a future tax year by the surviving spouse? Apparently so, given the Tax Court's decision in ***Rose*** discussed below.

Comment: What about the need to carry over suspended passive losses or "qualified business losses" under **Code §199A**. Or, **Code §461(l)** "excess business losses" which get converted into an NOL carryover? Credits such as that for energy related costs do not carry since they are nonrefundable.

Facts: The taxpayers filed a joint return for 1998 in which they reported an AMT payment of $708,181. The AMT reported on the '98 tax return resulted from the exercise by the husband of ISOs granted by his employer. The couple subsequently got divorced in 2002. He then remarried and filed joint returns with his new wife until his death in 2004. At the time of his death, he had *not* used all of the MTC that resulted from the prior exercise of the ISOs. Nevertheless, his new wife attempted to use the unused MTC on her own returns that she filed after his death.

Tax Court Decision: The Court agreed that any tax attributes personal to the decedent "went to the grave with him." Therefor, his widow was *not* permitted to use her deceased husband's minimum tax credit. The Court did note that neither the Code nor the relevant regs "provided an answer" as to whether she was entitled to the applicable AMT credit. But, it was clear that case law, along with certain indirectly related regs, dictated that she was *not* entitled to this tax attribute. By way of comparison, a few cases have analyzed whether, and to what extent, NOLs sustained before or after the marriage may be used on a joint return. In ***Calvin*, 16 AFTR 2d 6025 (10th Cir., 1965)**, the taxpayers attempted to use NOLs that originated with the wife *before* their marriage to offset the husband's income earned in the first year *after* they had married. Relying on **Reg. §1.172-7**, the Appeals Court concluded that, for losses occurring *before* marriage, "the net operating loss provisions are personal to the taxpayer who incurred such loss and only available in other years to offset income of the *same* taxpayer." In ***Zeeman*, 21 AFTR 2d 1380 (2nd Cir., 1968)**, the Appeals Court relied on the reasoning in ***Calvin*** to deny a loss carryback to the taxpayer in the "reverse situation," who sustained losses *after* her husband's death and then sought to carry them back to joint returns in which *all* of the reported income belonged to her husband. The Court in ***Zeeman*** noted that the merger of married couples' income for tax purposes "is linked between different years for only so long as they are married." Other court decisions also confirm that some tax attributes "die with a taxpayer." In ***Rose*, TC Memo 1973-207TC**, the Tax Court held that a taxpayer may only carry forward *one-half* of the NOLs reported on joint returns during her marriage and offset them against separate income earned *after* her husband's death. The determining factor in ***Rose*** "was the extent to which the taxpayer participated in the risk when the loss occurred; the taxpayer was essentially an equal partner with her husband and was therefore entitled to half of the NOLs, whereas the losses attributable to her husband's participation in the business were *not* available for her to use in subsequent years." The analysis in ***Rose*** accords with the treatment of NOLs under **Rev. Rul. 74-175**, which limits the deductibility of capital and net operating losses sustained by a decedent during his last tax year to the final return (whether separate or joint) filed on his behalf; the estate is *not* eligible to deduct such losses. Similarly, under **Reg. §1.170A-10(d)(4)(iii)**, a taxpayer may *not* deduct the excess charitable contributions of his or her deceased spouse. **(Code §56; Tax Attributes)**

Comment: The bottom line was that even though the Tax Court recognized that "the purposes of the AMT credit and the NOL carryover are *not* identical, it nonetheless found informative the authorities limiting the transfer of NOL carryovers between spouses."

Code §61 - Gross Income:

☞Supreme Court Rules Proposed Student Loan Debt Relief Program Illegal (*Biden vs. Nebraska*, No. 22-506 (S. Ct., 6/30/2023))

The Supreme Court dismissed President Biden's student-loan forgiveness plan, stating that such relief under "is illegal and cannot move forward." President Biden's plan would have cancelled up to $20,000 in student debt for federal borrowers who are Pell Grant recipients and up to $10,000 in student debt for other federal borrowers making under $125,000 per year. The Supreme Court ruled that the **Higher Education Relief Opportunities for Students Act of 2003 (HEROES Act)**, which gives the Secretary of Education the ability to waive or modify student-loan balances "in connection with a war, other military operation, or national emergency," is *not* the appropriate law to carry out this relief. **(Code §61(a)(11); Student Loans)**

> **Comment:** The decision was the result of two lawsuits. In one of the lawsuits, ***U.S. Department of Education vs. Brown*, No. 22-535 (S.Ct., 6/30/2023)**, the Court ruled that the plaintiffs did *not* have standing to even bring the action before the court.

☞Correctly Handling Pre- v. Post-Death Interest on Bonds (*Hitchman*, TC Summ. Op. 2023-18 (5/2/2023))

When a taxpayer inherits EE or I savings bonds that have *not* yet reached maturity, the reporting requirements can be complicated. One option on owning EE or I bonds is to elect to defer reporting the interest on the inherited bonds as income for federal tax purposes until the *earlier* of the year the bonds mature or when they are redeemed. One of the issues is that if the EE or I bonds are inherited and they have *not* yet matured, who is taxed on the pre-death accrued interest? The answer depends on how any pre-death interest is treated on the decedent's final personal income tax return. If the executor elects to include all pre-death interest on that final return, then the beneficiary reports any post-death interest on **Form 1040** when the bonds mature or are cashed in, whichever comes first. Conversely, if the executor does *not* include pre-death interest on the decedent's final return, then the beneficiary owes federal income tax on *all* pre- and post-death interest on the earlier of the bond's maturity or redemption.

In this recent case, a son who inherited a savings bond from his father had it reissued in his name and later redeemed it. Treasury Direct sent the son a **Form 1099-INT** reporting interest that accrued from the original date when his dad bought the bond. Nevertheless, the son reported on his personal return only the amount of interest that accrued from when the bond was reissued in his name until he cashed it in (i.e., the post-death interest). Since the father never reported any interest earned on the bond while he was alive, and no election was made by his executor to include all the interest on the dad's final **Form 1040** when he died, the Tax Court agreed that the son was responsible for reporting the *total* amount of interest. **(Reg. §1.61-7(b)(3); Accrued Interest)**

☞IRS Guidance on Digital Asset Reporting (Tax Tip 2023-45)

All taxpayers filing 2023 tax year **Form 1040** are required to check a box indicating whether they received digital assets as a reward, award or payment for property or services or disposed of any **digital asset** that was held as a capital asset through a sale, exchange or transfer. Examples of digital assets transactions include:

- A sale of digital assets
- The receipt of digital assets as payment for goods or services provided
- The receipt or transfer of digital assets for free, without providing any consideration, that does *not* qualify as a bona fide gift
- The receipt of new digital assets as a result of "mining and staking activities"
- The receipt of new digital assets as a result of a "hard fork"
- An exchange of digital assets for property, goods or services
- An exchange or trade of digital assets for another digital asset(s)
- Any other disposition of a financial interest in digital assets

Reporting Digital Assets Transactions: If the "yes" box is checked, taxpayers must report all income related to their digital asset transactions: (1) Taxpayers should use **Form 8949, Sales and other Dispositions of Capital Assets**, to figure their capital gain or loss and report it on **Schedule D, Capital Gains and Losses**; (2) If the transaction was a gift, they may have to file **Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return**; or (3) If individuals received any digital assets as compensation for services or disposed of any digital assets they held for sale to customers in a trade or business, they must report the income as they would report other income of the same type (e.g., report W-2 wages on **Form 1040, line 1a**, or inventory or services on **Schedule C**. **(Misc.; Digital Assets)**

☞**New Reporting Requirements for Digital Asset Sales or Exchanges (IR-2023-153)**
New proposed regulations have been released that would require brokers to report sales and exchanges of digital assets by customers. The proposed regulations cover a range of digital asset issues where there have previously been questions, including defining brokers and requiring proceeds to be reported to the IRS on *new* **Form 1099-DA**.

"These proposed regulations are designed to help end confusion involving digital assets and provide clear information and reporting certainty for taxpayers, tax professionals and others," said IRS Commissioner Danny Werfel. "A key part of this effort fits in with the larger IRS compliance focus on wealthy taxpayers. We need to make sure digital assets are *not* used to hide taxable income, and the proposed regulations are designed to provide a clearer line of sight into activities by high-income people as well as others using them. We want to make sure everyone pays what they owe under the tax laws, and our research and experience demonstrate that third-party reporting improves compliance. We welcome comments on these proposed regulations as we work to finalize the rules in this complex and evolving area."

For sales or exchanges of digital assets that take place *on or after* Jan. 1, 2025, the proposed regulations would require brokers, including digital asset trading platforms, digital asset payment processors and certain digital asset hosted wallet providers, to report gross proceeds on a newly developed **Form 1099-DA** and to provide payee statements to customers. Brokers, in certain circumstances, would also be required to include gain or loss and basis information for sales that take place *on or after* Jan. 1, 2026, on these information returns and statements, so that customers have the information they need to prepare their tax returns.

The proposed regulations would also require “real estate reporting persons,” such as title companies, closing attorneys, mortgage lenders and real estate brokers, who are treated as brokers for dispositions of digital assets, to report the disposition of digital assets paid as consideration by real estate purchasers to acquire real estate in real estate transactions that close *on or after* Jan. 1, 2025. These real estate reporting persons would also be required to include on **Form 1099-S** the fair market value of digital assets paid to sellers of real estate in real estate transactions that close *on or after* Jan. 1, 2025.

Finally, the proposed regulations set forth gain (or, loss) computation rules, basis determination rules and backup withholding rules applicable to digital asset sale and exchange transactions and propose many useful definitions. **(Code §61; Digital Assets)**

☞**Including Cryptocurrency Staking Rewards in Income (Rev. Rul. 2023-14)**
Cash method taxpayers “who stake cryptocurrency native to a proof-of-stake blockchain,” while also receiving additional units of cryptocurrency as rewards when validation occurs, are required to include the fair market value of the “validation rewards” in gross income in the tax year in which the taxpayer “gains dominion and control over the validation rewards.” This is true whether or not the staking is done through a cryptocurrency exchange. Fair market value is determined at the time the taxpayer gains

dominion and control over the awarded cryptocurrency. The taxpayer is considered to have "dominion and control" when they have the ability to sell, exchange, or otherwise dispose of the validation reward. **(Code §61; Cryptocurrency)**

> **Comment:** Some taxpayers have taken the position that token rewards they received through a "proof-of-stake blockchain" are created property that is *not* taxed on receipt, but instead, on disposition.

> **Comment:** The IRS clarified that this ruling does *not* apply to any issue or transaction other than "cryptocurrency staking validation rewards."

☞**Service Updates Audit Technique Guide for Attorneys**

The IRS has an updated **ATG handbook** instructing agents on the various issues that they should look for when auditing lawyers and law firms. For example, IRS examiners will check to see that attorneys correctly reported all types of income, including contingent and referral fees, retainers and cash payments. Auditors will reconcile attorney trust accounts to other bank accounts owned by the lawyer. In addition, write-offs claimed for travel and entertainment will get extra scrutiny. And special attention will be paid to deductions taken for costs advanced by lawyers. **(Misc.; ATG - Attorneys)**

☞**Advance Litigation Support Payments Currently Taxable (*Novoselsky*, TC Memo. 2020-68 (5/28/2020))**

The Tax Court has confirmed that litigation support payments received in advance by a lawyer must be currently included in his gross income. In this instance, the lawyer worked on a contingency fee basis, with clients or third parties paying for the costs involved with the litigation up front. And, the lawyer's responsibility to repay these amounts was contingent on his recovering the fees or costs as a result of the litigation. But, if a case was unsuccessful, he did *not* have to repay any of these funds received. Nevertheless, he treated the payments as "loans" for tax purposes which the Tax Court rejected since the arrangement between the lawyer and the payer "was *not* indebtedness because the lawyer's obligation to repay the funds was conditioned upon the occurrence of a future event." **(Code §61; Advance Payments)**

> **Comment:** Contrast this situation with the more common arrangement where "if you don't win, you don't pay" that most law firms offer. There, the lawyer does *not* received any advance payments for anticipated costs such as expert witnesses, but they would get reimbursed first out of any judgment, should they win the case (along with a contingency fee normally ranging from 33% to 40%). Nevertheless, they are entitled to deduct expenses that the firm covers up front, even though they might eventually recover these costs. The IRS is *not* happy with these write-offs (even though you would have to include the tax benefit of them (i.e., pursuant to **Code §111** later on when they are reimbursed), but the TCJA endorsed this approach as allowable under the tax law.

☞**Malpractice Settlement Includible in Gross Income (*McKenny*, No. 18-10810 (11th Cir., 9/1/2020))**

The 11th Circuit, *reversing* a 2018 Tax Court decision, held that a settlement from a tax accounting firm for malpractice should be included in gross income. In this instance, an accounting firm advised a their client to restructure his business as an ESOP-owned S corporation. But, the transaction was later classified as a tax shelter, resulting in a significant tax bill from the IRS. The client then sued the accounting firm, claiming it made errors and did *not* implement the suggested plan. The parties ended up settling the case for much less than what he had to paid to the Service in the form of additional taxes, interest and penalties which the Appeals Court concluded to be taxable. **(Code §61; Malpractice Settlement)**

Code §66 - Treatment of Community Income:

☞**Community Property Law Dictates Items of Income/Loss Be Shared Equally (*Wienke*, TC Memo. 2020-143 (10/14/2020))**

A couple residing in CA owned 28 rental homes. For the tax years in question here, they decided to file separate federal returns as they were in the process of obtaining a divorce (there was an outstanding restraining order for domestic violence against his wife). The wife reported income from 18 of the properties on her return, and the husband reported the remainder. Upon audit, the IRS calculated total income and expenses on all 28 rentals and then allocated 50% to the wife and 50% to the husband. Under Calif. community property law, each spouse is deemed to own an undivided one-half interest in the community estate, which includes both spouses' income, unless a spouse elects to treat the community property income separately. In this instance, the couple failed to make this necessary election. As a result, the IRS was correct in reallocating the rental income. **(Code §66; Community Property)**

Code §71 - Alimony - Pre-2019 Decrees:

☞**Erroneous Alimony Deductions Continue to Be Claimed**

According to a recent TIGTA audit, the Service "continues to fail with regard to policing the tax rules on alimony." After the changes made by the **TCJA**, taxpayers seeking to deduct alimony payments after 2018 are required to include the ex-spouse's Social Security number and the original date of the divorce or separation agreement on **Schedule 1** of the **Form 1040**. Treasury inspectors, however, found that the Service is *not* reviewing cases with invalid SSNs. Furthermore, the IRS is allowing some alimony deductions on returns showing an divorce agreement date *after* 2018.This is in spite of the fact that alimony paid under post-2018 divorce or separation agreements is *not* deductible. As a result, ex-spouses are *not* taxed on any alimony that they receive under these arrangements. **(Code §71; Alimony)**

> **Comment:** Older divorce agreements can be modified to follow these rules if *both* parties agree. This might make sense where a lesser amount should be paid each month now that such payments are nontaxable to the recipient ex-spouse. In response to the findings of this TIGTA audit report, the IRS stated that "it will update its internal guidance but will *not* reject noncompliant returns."

☞**Alimony Deductions Denied - Payments Deemed to Be Property Settlement (*Redleaf*, 130 AFTR 2d 2022-XXXX (8th Cir., 8/5/2022))**

The taxpayer made deferred cash payments to his ex-wife if she agreed to waive any rights to "permanent spousal maintenance." The taxpayer deducted the $51 million in cash payments in 2012 and 2013 as alimony. Nevertheless, his ex-spouse did *not* include the payments in her gross income since she considered the payments as nontaxable property settlement payments being made incident to divorce under **Code §1041**. Both taxpayers received notices from the IRS and petitioned the Tax Court for redeterminations. The Tax Court consolidated the cases and granted summary judgment in favor of the ex-wife. Focusing on the definition of "deductible alimony" under former **Code §71(b)(1)**, the Tax Court concluded that (1) the taxpayer's obligation to make payments would have continued if his ex-spouse had died *before* the final payment was due and (2) state law designated the payments as *not* includible in her gross income and *not* deductible by the taxpayer. The 8th Circuit subsequently *affirmed* the lower court's decision. **(Code §71; Alimony)**

> **Comment:** The issue of deductible is now moot due to the changes made by the **TCJA** which decreed that post-2018 payments (whether it be for the ex-spouse's maintenance, a property

settlement or child support) are not deductible.

☞**Connecting Alimony to Child-Support Related Contingencies Nixes Deduction (*Rojas,* TC Memo. 2022-77 (7/18/2022))**

Even for pre-2019 divorce decrees (i.e., where alimony payments might still be tax deductible), basing the projected alimony amounts to a child-related contingency resulted in any potential income tax deduction being denied. In this instance, pursuant to a couple's divorce decree, monthly family support payments made by the ex-husband ended when either the children reach age 18 or the ex-wife remarried. If the ex-wife remarried while the children were still minors, the maintenance payments to the ex-wife would also reduced. Because of this "child-related contingency," *all* payments made by the ex-husband were nondeductible. The Tax Court also stated that it did *not* matter that the relevant language in the divorce decree included both "child-related" and "spouse-related" contingencies. **(Code §71; Alimony)**

> **Comment:** The taxpayers were married in 1995, separated in 2010, and finally divorced in 2012. The family court entered a judgment of dissolution containing child, spousal, and family support. The amounts were $0, $0, and $4,500 per month, respectively. The payments under "family support" provided that upon a child's emancipation (i.e., upon reaching age 18) the payments shall cease. In 2016, the taxpayer paid $69,888 in alimony and claimed a deduction of $69,880, which the IRS disallowed.

Code §104 - Compensation for Injury or Sickness

☞**Legal Malpractice Settlement Not Excludible from Income (*Blum,* 129 AFTR 2d 2022-XXX (9th Cir., 3/22/2022))**

The 9th Circuit *affirmed* the Tax Court's decision that legal malpractice settlement proceeds would *not* be excludible under **Code §104**. The taxpayer in this instance was injured after being directed to sit in a broken wheelchair. She retained an attorney, but the trial court granted summary judgement to the hospital. She then brought a malpractice suit against her attorneys and received $125,000 from the malpractice lawsuit. Nevertheless, she did *not* report the settlement income on her tax return. The taxpayer insisted that the settlement should *not* be taxable under **Code §104(a)(2)** which excludes damages received "on account of personal physical injuries" from income. But the Circuit Court agreed with the IRS that the settlement agreement specifically identified the lawsuit as a malpractice claim and did *not* result from a personal injury suit. Even though the taxpayer felt that the award was a substitute for what she should have received from the hospital for its negligence, the settlement compensated her for the harm caused by her lawyers' malpractice making the settlement proceeds taxable. **(Code §104; Personal Injury)**

Code §105 - Disability Payments:

☞**Taxes Owed on Disability Payments (*Hailstone,* TC Summ. Op. 2023-17 (4/24/2023))**

The Tax Court confirmed that a couple's disability insurance payments should be included in their gross income. In addition, an accuracy-related penalty was correctly assessed for their substantial understatement of income tax owed on this unreported income. Under **Code §105(c)**, payments made under a disability insurance policy that *cannot* be traced to *employer* contributions are in fact excludible from gross income. But in this instance, the husband's employer had paid *all* of the premiums for the disability insurance although it could have allowed him to instead pay a portion of the premiums. The husband filed a workers' compensation claim and received $105,000, which was reported on his **Form**

W-2. Yet, the couple failed to report the payments on their joint federal tax return. The Court concluded that the couple "did not act in good faith" in *not* reporting the disability payments and upheld the penalty as well. **(Code §105(c); Disability Payments)**

> **Comment:** Under the policy, the company's employees were *not* required to contribute to the policy premiums. Instead, the company was required to pay 100% of the premiums. The policy allowed the company to have a covered employee pay 25% of the premiums if there were three or more insured employees. However, the company did *not* choose this option. Nevertheless, the taxpayer attempted to assert that the disability payments should be excludible from his gross income under **Code §105(c)** because "although the company paid the premiums for the disability insurance, the company could have allowed him to do so."

> **Comment:** The IRS examined petitioners' tax return for the year in question through its **Automatic Underreporter (AUR) program**. The IRS then issued a **CP2000 Notice** and proposed a deficiency of $21,910 with an accuracy-related penalty of $4,382. The taxpayers, however, did *not* respond to the **CP2000 Notice**. And, keep in mind that, generally speaking, determinations set forth in an IRS notice of deficiency are presumed correct, and the taxpayer bears the burden of proving that the determinations are in error.

Code §108 - Insolvency Exception:

☞**COD Income Excluded Due to Insolvency Exception (*White*, TC Memo. 2023-77 (6/21/2023))**

Even though this small business owner had the $15,000 principal balance outstanding on a loan forgiven, she was *not* required to include it in gross income due to the insolvency exception under **Code §108**. Taxpayers whose liabilities are *greater* than the fair market value of their assets (including IRA and retirement plan accounts for individuals) are permitted to exclude income from forgiven indebtedness up to the amount of their insolvency. In this instance, the taxpayer owned a body sugaring business took out a $15,000 small-business loan. One year later, after she stopped paying on the loan, the bank wrote off the debt on its books and sent her a **Form 1099-C** reporting cancellation of debt (COD) income. The Tax Court agreed that her liabilities exceeded her assets by approximately $20,000. As a result, she was insolvent and the full amount of her COD income could be excluded by filing **Form 982** and listing this exception. **(Code §108; COD Income)**

> **Comment:** The reason that the Service would *not* settle this case at either the audit or appeals level was due to the fact that the taxpayer had *not* adequately substantiated that a family loan, the rental lease breach acceleration debt, or the estimated utility bills were bona fide debts. Instead, under the Service's calculation, the taxpayer's liabilities at the time of discharge totaled $29,936.07 against assets totaling $32,059.89. Thus, according to the IRS, the taxpayer was solvent by $2,123.82 and the cancellation of petitioner's loan constituted gross income.

☞**Cancelled Debt of SMLLC Included on Member's Form 1040 (*Jacobowitz*, TC Memo. 2023-107 (8/16/2023))**

A single-member LLC which is ignored as a separate entity for income (but *not* employment) tax purposes borrowed money from a bank but failed to repay it. Eight years later the bank finally issued a **Form 1099-C** for the cancelled debt amount of $35,000. The taxpayer/member argued that this COD income need *not* be reported on his **Form 1040** since it was the debt of the LLC (which was no longer in existence). The Tax Court disagreed and ruled that this forgiven debt was indeed includible in the taxpayer's gross income. **(Code §108; COD Income)**

Comment: Even if this had been a multi-member LLC (i.e., taxed as a partnership), any COD income at the entity level would have to be passed through on each member's K-1. Then, each member would have to personally report this income unless they could show a qualifying exception pursuant to **Code §108** (i.e., as shown in **Part I** on **Form 982**).

☞**Couple Not Eligible for Insolvency Exception on COD Income (*Hamilton*, No. 19-9000 (10th Cir., 4/7/2020))**

A couple whose student loan debt was discharged did *not* qualify for the "insolvency exclusion" (as shown on **Form 982**). Normally, taxpayers whose total liabilities are greater than the total fair market value of their assets as of the date that they are legally relieved of the underlying debt can exclude this "cancellation of debt income" up to the amount of their insolvency. In this instance, the couple, whose debt was forgiven, transferred $300,000 to their son's bank account, but they continued to use the money in the account to pay household expenses. As a result, these funds that were transferred to that account were considered as part of the parents' assets for when calculating the insolvency exception which, in turn, made them solvent and the waived debt taxable. **(Code §108; COD Income)**

Comment: Be careful when calculating the FMV of all assets otherwise available to the taxpayer for the "insolvency exception." Although we do *not* look to retirement plan and IRA assets to pay our day-to-day bills, along with meeting our other necessities, these assets must still be counted. And, when you include these amounts, you might find that the taxpayer is *not* insolvent at all (i.e., the total FMV of the assets that they own is in excess of the total debts that they are liable for).

Code §162 - Trade or Business Expenses:

☞**Some Taxpayers Allowed Deduction for Unreimbursed Business Expenses**

Most taxpayers lost this deduction when the **TCJA** eliminated 2% miscellaneous deductions (including those listed on **Form 2106**). Nevertheless, there are a number of exceptions as follows:

- Disabled workers who otherwise itemize their deductions on **Schedule A** are permitted to claim the cost of "impairment-related aids that enable them to function more easily at work."

- Statutory employees such as agent or commission delivery drivers, home workers, sellers of life insurance and some traveling salespeople can use **Schedule C** to deduct business related expenses

- Educators can write off up to $300 of unreimbursed expenses on **Schedule 1, Line 11** on **Form 1040**. And the cap increases to $600 for spouses who are both teachers and file a joint tax return

- Reservists or National Guard members are permitted to deduct overnight travel expenses for trips over 100 miles related to their training or military positions. Given that they itemize their deductions, these costs are listed on **Form 2106** and **Schedule 1, Line 12** on **Form 1040**

- Performing artists are also allowed to use **Form 2106** and deduct expenses on **Schedule 1, Line 12** of **Form 1040**. To qualify, they are required to have at least two employers, earned $200 or more in wages, had expenses over 10% of income, and have an AGI which does *not* exceed $16,000. **(Code §162; Unreimbursed Business Expenses)**

☞**Rent Paid by S Corporation to Shareholders Unreasonable (*Sinopoli*, TC Memo. 2023-105 (8/14/2023))**

In this instance, each shareholder owned one-third of an S corporation that operated fitness center franchises. The company did *not* have a central office location, but instead paid rent to each shareholder for use of their personal residences "as executive office space for monthly meetings." The corporation deducted about $300,000 in rent expense over multiple years for a total of 21 meetings at the homes (i.e., 12 in 2016 and 9 in 2017). The shareholders who received the rent treated the income as nontaxable under the rule that proceeds from a residence rented out 14 days or less in a year can be excluded from gross income. The Tax Court agreed with IRS that only $10,500 of rent was deductible. **(Code §162; Business Expenses)**

> **Comment:** The shareholders kept no records or minutes as to these meetings, and the $3,000 paid to each shareholder per month for these supposed meetings was deemed unreasonable. The IRS allowed no deduction for any 2015 meetings, and only 12 and 9 respectively for 2016 and 2017, and only then at a rate of $500 per meeting (i.e., so, $6,000 for 2016 and $4,500 for 2017).

> **Comment:** The Tax Court never addressed in its opinion whether the "Augusta rule" applied to exclude even the $10,500 of rent payments that were made by the S corporation. It simply spoke to the unreasonableness of the $290,900 deducted as "rent paid" along with inflated advertising expenses that were also denied. That said, if reasonable rent had been paid under a legitimate rental arrangement, then whether is comes from your S corporation or partnership, or an unrelated third-party, it should be excludible if the total days rented are less then 15 days annually (i.e., under **Code §280A(g)**).

> **Comment:** An employer such as an S corporation is certainly entitled to pay reasonable rent (i.e., which would be non-FICA dollars *not* subject to employment taxes) to its shareholder for the use of a home office. But, **Code §280A(c)(6)** would deny any deductions being taken on the shareholder's **Schedule E** for rental expenses. Nevertheless, specific language could be included in a written lease agreement that the S corporation would reimburse for its allocable share of home-related expenses such as utilities, home owner's insurance, etc. As a result, there would be no rental expenses to be otherwise reported on **Schedule E** (i.e., it would be a "naked **Schedule E**" with just the gross rental income being listed).

☞**Tax Rules for Business Related Travel Deductions (Tax Tip 2022-104)**

Business travel can be expensive with the cost of hotel bills, airfare or train tickets, cab fare, public transportation, etc. The good news is that business travelers may be able off-set some of those cost by claiming business travel deductions when they file their tax returns.

The IRS has now outlined the details behind those deductions that all business travels should know about. Business travel deductions are available when employees must travel away from their **tax home** or **main place of work** for business reasons. The travel period must be substantially longer than an ordinary day's work and a need for sleep or rest to meet the demands the work while away.

Travel expenses must be ordinary and necessary. They cannot be lavish, extravagant or for personal purposes.

Employers can deduct travel expenses paid or incurred during a **temporary work assignment** if the assignment length does *not* exceed one year (as long as that is the reasonable expectation as of the start of the proposed work assignment).

Travel expenses for **conventions** are deductible if attendance benefits the business and there are special rules for conventions held **outside North America**.

As detailed in this IRS "Tax Tip," deductible travel expenses "while away from home" include the costs of:

• Travel by airplane, train, bus or car between your home and your business destination.

• Fares for taxis or other types of transportation between an airport or train station to a hotel, from a hotel to a work location.

• Shipping of baggage and sample or display material between regular and temporary work locations.

• Using a personally owned car for business which can include an **increase in mileage rates**.

• Lodging and **non-entertainment-related meals**.

• Dry cleaning and laundry.

• Business calls and communication.

• Tips paid for services related to any of these expenses.

• Other similar ordinary and necessary expenses related to the business travel.

There are additional rules for self-employed individuals or farmers with travel deductions as follows:

• Those who are self-employed can deduct travel expenses on **Schedule C**,**Form 1040, Profit or Loss From Business, Sole Proprietorship**.

• Farmers can use **Schedule F**, **Form 1040, Profit or Loss From Farming**.

With regard to travel deductions for the National Guard or military reserves whereby they are entitled to claim a deduction for unreimbursed travel expenses (i.e., as shown on **Form 2106**) paid during the **performance of their duty**.

As with any business, it is critical to keep good records. **Well-organized records** make it easier to prepare a tax return. Therefore records such as receipts, canceled checks, and other documents that support a deduction should be readily available. **(Misc.; Travel Deductions)**

Comment: More detailed information can be found in the following publications:

IRS Pub. 463, **Travel, Gift, and Car Expenses**

IRS updates per diem guidance for business travelers and their employers

☞**Full-time Employee Allowed Travel Expense Deduction for Distant Side-Business (*Gonzalez*, TC Summ. Op. 2022-13 (7/18/2022))**

A full-time employee with a business on the side was permitted to deduct her vehicle-related travel expenses. She lived and worked in Palo Alto, Calif., while owning a small clothing design business in Los Angeles. Every other weekend, she would drive 800 miles round-trip from her home to Los Angeles to oversee operations of this side business. When audited by the IRS, she was prepared and presented the Service a detailed written log listing the dates traveled, miles driven and purpose of the trips. As a result, she was deemed to have met the strict substantiation rules for taking a Schedule C deduction with regard to these travel expenses. **(Code §162; Travel Expenses)**

> **Comment:** The bottom line is that she *not* only had good records, but more importantly, she established that her "tax home" was in Palo Alto where she was a full-time employee. Another key factor that was *not* discussed is, apparently, this was *not* an "indefinite travel arrangement" (i.e., expected to last more than 1 year). Otherwise, that could be another reason why travel expenses could be deemed as nondeductible.

> **Comment:** Another fact pattern to be cognizant of would be travel to distant rental properties, or numerous ones located in a large metropolitan area. For instance, if the taxpayer lived in the mid-west U.S. and their rental property in FL suffered significant damage as a result of a hurricane, then travel expenses involved with being on-site as repairs were made should deductible (airfare or mileage, hotel, meals, etc.).

> **Comment: Code §162(a)(2)** allows taxpayers to deduct traveling expenses if they are: (1) ordinary and necessary, (2) incurred while away from home, and (3) incurred in the pursuit of a trade or business. (Cf. ***Commr. v. Flowers*, 326 U.S. 465, 470–72 (1946)**)

☞**Educators' Deduction Increases to $300 for 2022 (IR-2022-70)**

Having not been adjusted for inflation since this deduction first came into the law in 2002, it is finally going to be increased from $250 to $300 for the 2022 tax year.

> **Comment:** Despite the rise in the inflation rate over the years, the limit remained at just $250. Going forward, however, increases to this deduction will now be done in increments of $50 based on future inflation (but remains at $300 for 2023 as well).

For 2022, an "eligible educator" will be eligible to deduct up to $300 of qualifying expenses. If they are married and file a joint return with another eligible educator, the limit increased to $600. However, not more than $300 for each spouse may be claimed as a deduction.

Educators are permitted to claim this deduction, even if they take the standard deduction. "Eligible educators" include anyone who is a kindergarten through grade 12 teacher, instructor, counselor, principal or aide in a school for at least 900 hours during the school year. Both public- and private-school educators qualify.

Eligible expenses include:

- Books, supplies and other materials used in the classroom

- Equipment, including computer equipment, software and services

- COVID-19 "personal protective equipment" (PPE) which are intended to prevent the spread of the disease in the classroom. This includes face masks, disinfectant for use against COVID-19, hand soap, hand sanitizer, disposable gloves, tape, paint or chalk to guide social distancing, physical barriers, such as clear plexiglass, air purifiers and other items recommended by the Centers for Disease Control and Prevention (CDC).

- Professional development courses related to the curriculum they teach or the students they teach. For these expenses, however, it may be more beneficial to claim another educational tax benefit, such as the lifetime learning credit (Cf. IRS Pub. 970, **Tax Benefits for Education, Chapter 3**).

> **Comment:** Keep in mind that "qualified expenses" do *not* include expenses for home schooling or for non-athletic supplies for courses in health or physical education. And, as with all deductions and credits, the IRS requires educators to keep good records, including receipts, cancelled checks and other documentation.

> **Comment:** Expenses qualifying for the educators' deduction are claimed on **Schedule 1, Line 11**.

☞Tax Home Where Business Was Located - No Travel Expense Deduction (*Deeb*, Civil Action 1:20-CV-1456-TWT (D.C., Ga., 2/4/2022))

The taxpayer living in Ga. but working extensively overseas was *not* permitted to deduct travel expenses since Ga. was *not* his home for tax purposes. Here, the taxpayer was a self-employed consultant with a home in the U.S. but who also owned a company in Azerbaijan and spent most of his time working in that country. He attempted to deduct $95,000 in travel expenses on Schedule C insisting that his "tax home" was in Ga., where he resided. The Tax Court agreed with the Service, confirming that his tax home was in Azerbaijan, where his place of business was located. **(Code §162; Travel Expenses)**

> **Comment:** Remember, if the travel was "temporary" (i.e., expected to last less than 12 months and, in fact, actually did), then an argument could have been made for the deductibility of these travel expenses.

☞Tax Home Isn't Always Where You Live (*Brown*, 11th Cir.)

This recent case demonstrates, once again that your "tax home" is *not* necessarily where you reside. In this instance, a self-employed consultant lived in Georgia but worked at his client's offices in N.J. four days each week. Nevertheless, he attempted to deduct his weekly travel to and from N.J. as a "business expense" on his Schedule C, arguing that his tax home was in Georgia, where he resided. The Tax Court shot that down, saying his tax home was in N.J., in part because his business income was derived from his N.J. client and also the fact that his contract with that client was indefinite, *not* temporary. Now, an appeals court has *affirmed* the Tax Court's decision. (***Brown*, T.C. Memo. 2019-30 (4/8/2019)**) **(Code §162; Tax Home)**

☞Dog's Location Helps Determine Taxpayer's Domicile (*Gregory Blatt*, N.Y. Division of Tax Appeals, No. 826504 (2/2/2017))

The taxpayer resided in New York until he became the CEO at Match.com, based in Dallas. In 2009, he signed a one-year lease for an apartment in Dallas. His employment contract listed his principal place of employment as Dallas, but he continued to maintain his New York apartment. He then filed a New York nonresident/part-year resident tax return for 2009 and 2010. On audit, the New York taxing agency claimed that he continued to be domiciled in New York and owed income tax of $430,065. A state court disagreed after evaluating the factors supporting the taxpayer's change in domicile to Texas, among the most important being his decision to move his dog to Texas. According to the court, the move of items that are "near and dear tend to demonstrate a person's intention" to change domicile. **(Code §162; Taxpayer Domicile)**

> **Comment: Domicile is becoming even more of an important issue as hundreds of thousands of taxpayers relocate to no-tax states such as Texas and Florida.**

☞Special Tax Deduction Available for Reservist's Travel Expenses

Individuals who are reservists in the Armed Forces or who are members of the National Guard get a special tax break in being able to deduct overnight travel expenses even if they cannot itemize their deductions on Schedule A. If their trip exceeds 100 miles, they are permitted to deduct expenses for transportation, meals, lodging and incidentals, up to the maximum federal per diem rate for the area in which they live. More importantly, even though the calculation is done on Form 2106, they are allowed to deduct it on page one of Form 1040 (i.e., Line 21, "Other Deduction"), and *not* on Schedule A. **(Code §162; Reservist's Expenses)**

Code §163 - Interest Expense:

☞Distinguishing Investment Income for Sec. 163(d)(3) Purposes v. Sec. 1411 3.8% Medicare Surtax

Code §1411 applies to "net investment income" which is somewhat similar, but more inclusive, than the definition that is used for taking investment interest expense on **Form 4952** (which flows over to **Schedule A**), increased by any net passive income. On the IRS website, "net investment income" for purposes of the 3.8% Medicare surtax is defined as:

> *"In general, investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer (within the meaning of **Code §469**)"*

For purposes of applying the 3.8% Medicare surtax "net investment income" is defined as:

> *"In order to arrive at Net Investment Income, Gross Investment Income is reduced by deductions that are properly allocable to items of Gross Investment Income. Examples of deductions, a portion of which may be properly allocable to Gross Investment Income, include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, tax preparation fees, fiduciary expenses (in the case of an estate or trust) and state and local income taxes."*

> **Comment:** This IRS guidance is a bit outdated here due to the passage of the **TCJA** which did away with 2% miscellaneous itemized deductions, as well as putting a $10,000 cap on state and local taxes (i.e.., SALT). As a result, the "net investment income" amount subject to the surtax is going to be higher since these deductions such as management advisory and tax preparation fees are no longer allowed (or, are otherwise curtailed). In other words, you can only deduct investment related expenses against gross investment income if they are still permitted after the passage of the **TCJA**.

Some common types of income that are *not* considered to "Net Investment Income" for purposes of applying the 3.8% Medicare surtax are:

> *"Wages, unemployment compensation; operating income from a **nonpassive** business, Social Security Benefits, alimony, tax-exempt interest, self-employment income, Alaska Permanent Fund Dividends (Cf. **Rev. Rul. 90-56**) and distributions from certain Qualified Plans (i.e., those described in **Code §§401(a), 403(a), 403(b), 408, 408A or 457(b)**)."*

According to the IRS, the common types of gains that are included in the definition of "Net Investment Income" include:

*"To the extent that gains are **not** otherwise offset by capital losses: (1) Gains from the sale of stocks, bonds, and mutual funds; (2) Capital gain distributions from mutual funds; (3) Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence); and (4) Gains from the sale of interests in partnerships and S corporations (**to the extent the partner or shareholder was a passive owner**). (Cf. **Reg. §1.1411-7** of the 2013 proposed regs)*

Comment: So, to the extent that the gain from the sale of a principal residence is excluded under the **Code §121** provisions (i.e., $250,000 or $500,000, depending on filing status), this type of gain would *not* fall under the definition of "Net Investment Income" for purposes of the **Code §1411** 3.8% Medicare surtax.

If there is a sale of S corp stock (or, a partnership interest), a ***passive*** **shareholder/partner** (i.e., one who does *not* otherwise "materially participate" in the underlying day-to-day activities of the business) could be subject to the 3.8% Medicare surtax either because it was a capital gain, or because they had only been a passive investor in the S corporation or partnership. And, since a C corporation is *not* a "flowthrough entity," the shareholder's material participation status is *not* even considered. As a result, gains from the sale of C corporation stock by a any owner (i.e., nonpassive or passive investor) would be considered "Net Investment Income."

Comment: If the shareholder had materially participated in the S corporation business (i.e., they were *nonpassive*), then the gain on the sale of their stock (or, a sale of the company's assets) would *not* be subject to the Medicare surtax, even though the LTCG on the sale of their stock could still possibly count as "investment income" on **Form 4952** (given an election is made to *not* take advantage of the special 15% or 20% marginal tax rates for LTCG or qualified dividends) should they need to deduct any investment interest expense. In other words, though the interplay of the **Form 4952** rules under **Code §163(d)(3)** for investment interest expense v. those on **Form 8960** for the **Code§1411** 3.8% Medicare surtax can be confusing, **they are independent of each other**.

Even on a sale of an S corporation's or LLC/partnership's assets with the respective types of gains/losses flowing through on a K-1 to a *nonpassive* shareholder would still have to each be looked at more closely in certain instances (i.e., to ascertain whether or not they should be included in the definition of "Net Investment Income"). For example, assume that a LLC/partnership owned a building where they leased out ½ to unrelated third-parties (with the other half being used in a nonpassive "self-rental" situation) which was then sold. The net gain on the sale of the "self-rental" portion would be *nonpassive* income to the owners. But a portion of the Sec. 1231 gain on the sale of the building (i.e., that part rented out to third-parties) would be *passive* income assuming that the shareholder was *not* a "real estate professional") and therefore subject to the 3.8% Medicare surtax.

Offsetting NII Tax with Credits: Any federal *income* tax credit that may be used to offset a tax liability imposed by **Subtitle A** of the Code may be used to offset the NII. However, if the tax credit is allowed only against the tax imposed by **Chapter 1** of the Code (i.e., regular *income* tax), those credits may *not* be used reduce the NIIT. For example, foreign income tax credits (**Code §§27(a)** and **901(a)**) and the general business credit (**Code §38**) are allowed as credits only against the *income* tax imposed by **Chapter 1** of the Code, and therefore may *not* be used to reduce any NIIT liability. But if any foreign income taxes are instead claimed as an income tax *deduction* (i.e., versus a tax credit), some (or, all since such taxes are *not* "state and local taxes" for purposes of the $10,000 cap) of the deduction amount may deducted against NII (i.e., given that the taxpayer otherwise itemizes their deductions on **Schedule A** v. taking the standard deduction).

Comment: Additional information about the NIIT can be found in the 2013 final **regulations** and in a new 2013 proposed **regulation** published on Dec. 2, 2013.

"Net Investment Income" for Form 4952: Under **Code §163(d)(3)** (as opposed to "business interest expense" limitation under **Code §163(j)**), "investment interest expense" (e.g., monies borrowed to purchased portfolio assets such as stocks or bonds) can only be deducted if the taxpayer otherwise itemizes their deductions on **Schedule A**, and to the extent of "net investment income" as shown on **Form 4952**. As key point to be made following the discussion above concerning the 3.8% Medicare surtax under **Code §1411** is that even though, for instance, a capital gain or Sec. 1231 gain is *not* considered "Net Investment Income" for the surtax tax (i.e., since the owner is **nonpassive** in the underlying business that generates such gains on the sale of the owner's interest, or the assets of the business), it might nevertheless be considered "investment income" for **Form 4952** purposes in offsetting "investment interest expense" (given that an election is made *not* to take advantage of the special 15% and 20% marginal tax rates for LTCGs and qualified dividends).

Comment: Now that 2% miscellaneous deductions are no longer allowed on **Schedule A**, expenses such as managing advisory fees and state and local taxes will *not* serve to reduce gross investment income, thus leaving a larger amount of net investment income to offset any investment interest expense. In other words, this was a "disadvantage" when calculating NII by *not* allowing these deductions, but an "advantage" when it comes to determining "net investment income."

"Investment Interest Expense" on Form 4952: Investment interest expense is interest paid or accrued on a loan or part of a loan that is allocable to "property held for investment." Investment interest expense, however, does *not* include any of the following:

- Personal interest under **Code §163(h)**, including qualified residence interest

- Interest expense that is properly allocable to a passive activity under **Code §469**

- Any interest expense that is capitalized, such as "construction period interest" subject to **Code §263A**

- Interest expense related to tax-exempt interest income under **Code §265**

- Interest expense, disallowed under **Code §264**, on indebtedness with respect to life insurance, endowment, or annuity contracts issued *after* June 8, 1997, even if the proceeds were used to purchase any property held for investment.

Property held for investment: "Property held for investment" includes property that produces income, *not* derived in the ordinary course of a trade or business (e.g., nonpassive rents on **Schedule E** or **Form 8825** received in a "self-rental" situation or by a "real estate professional"), from interest, dividends, annuities, or royalties. It also includes property that produces gain or loss, *not* derived in the ordinary course of a trade or business, from the disposition of property that produces these types of income or is held for investment. **However, it does *not* include an interest in a passive activity.**

Exception for "Working Interest in Oil or Gas:" A working interest in an oil or gas property that an investor holds directly or through an entity that does *not* limit their liability exposure (e.g., general partnership v. an LLC) is considered "property held for investment," but only if the taxpayer does *not* materially participate in the activity (i.e., they are passive under **Code §469**).

Electing to Include Qualified Dividend Income and Net Capital Gains in Investment Income: The definition of "net investment income" **excludes** qualified dividend income and net LTCGs (i.e., the excess of net long-term capital gains over net short-term capital losses) unless the taxpayer elects to include all or part of these included as investment income (**Code §163(d)(4)(B)**). The election for gains is available only for net capital gains resulting from the disposition of property held for investment. As a result, Sec. 1231 gains (including "unrecaptured Sec. 1250 gain" due to S/L depreciation which is taxed at no more than a 25% marginal rate) treated as long-term capital gains are *not* available for the election. **If the election is made however, the amount of qualified dividend income and net capital gain now included in net investment income is no longer eligible for the favorable capital gains rates.** In effect, this causes the elected amount to be treated as *ordinary* income and potentially taxed at rates as high as 40.8% (37% + 3.8% net investment income tax).

Comment: But, from a mathematical standpoint, even though the special 15% and 20% marginal tax rates are sacrificed so as to include net LTCGs and qualified dividends as additional sources of "investment income" for **Form 4952** purposes, these amounts would be offset by the additional ordinary deduction of investment interest expense which is now flowing from **Form 4952** over to **Schedule A** as an itemized deduction. In other words, the taxpayer is giving up the right to a special 15% or 20% marginal tax rate on the qualified dividends or LTCGs, but they are freeing up a deduction that can offset what could be ordinary taxable income taxed at up to a 37% marginal rate.

Comment: The election is made on or before the due date (including extensions) of the income tax return for the tax year in which the net capital gain is recognized or the qualified dividend income is received (**Regs.§1.163(d)-1(b)**).

Comment: When the election is made and the taxpayer has net capital gains in the 15%, 20%, and 28% rate categories, those subject to the 15% and 20% rates are treated as ordinary income *before* those subject to the 28% rate (**Code §1(h)(4)**).

Comment: Obviously, an election should *not* be made if a taxpayer has sufficient other current-year net investment income to allow a deduction of all investment interest expense. Furthermore, because disallowed investment interest expense carries over *indefinitely*, deciding whether to make the election may require an analysis that includes a number of future tax years (and, the marginal tax rates that the taxpayer expects to be subject to).

Example: "Electing to Include Net Capital Gains in Investment Income"
For the current tax year, John has $250,000 of taxable income, files as an unmarried taxpayer, and is in the 32% tax bracket. He is subject to the 3.8% net investment income tax since his taxable income exceeds $200,000. John's income includes $2,000 of interest income and $6,500 of net long-term capital gain. He also has $5,000 of investment interest expense from broker margin accounts. He expects his income and deductions for the following tax year to be similar to the current tax year. Without an election, John can deduct $2,000 of his current year's investment interest expense and carry forward the remaining $3,000 indefinitely. **(Code §§163(d)(3) & 1411; Interest Expense & NIIT)**

☞Reg. 1.163-10T Election No Longer Necessary - Strict Application of "Tracing Rules"

Because of the **TCJA**, it is no longer necessary to make a "10T election" so as to avoid the automatic classification of the interest due to a "qualified equity indebtedness" (QEI) loan as additional "qualified residence interest" which had been otherwise deductible on Schedule A. This prior exception for the interest paid on up to $100,000 of qualified equity indebtedness could be treated as additional mortgage interest (i.e., even if the funds had been used for "consumer purposes"). But in cases where the funds from an equity loan were used, for example, to finance trade or business interest expense (e.g., on Schedule C/F) a taxpayer could elect *not* to have the "10T regs apply and instead choose to trace such interest expense under the "8T regs" (and take this interest expense as a for-AGI deduction).

The **TCJA** eliminated the $100,000 QEI exception and now as was the case with QHI interest for AMT purposes, all interest expense incurred by a taxpayer must be "traced" to the *use* to which the borrowed monies were put. As a result, it is no longer necessary to "elect out" of the QRI regs under **Reg. §1.163-10T**.

Example: "10T Election Prior to 2018"

Gary has sufficient equity in his home to take out a $100,000 loan at a 5% interest rate. But he would like to use it for his Schedule C business. Absent a "10T election" this "qualified equity indebtedness" (QEI) loan and the interest thereon would fall under **Code §163(h)** as additional "qualified residence interest" (QRI) and would be deductible on Schedule A (assuming that Gary chooses to itemized his deductions). In order to reduce his self-employment income (and otherwise have a for-AGI deduction v. an itemized deduction), he makes a "10T election" to simply list the $5,000 of interest expense for the year on Schedule C. In other words, there was no formal "election statement" needed on his return for that tax year in order to do this. Just simply listing this trade or business interest on Schedule C was deemed sufficient to indicate his choice to instead fall under the "tracing rules" of **Reg. 1.163-8T**. **(Code §163(h); Interest Expense)**

> **Comment:** If Gary had instead used this $100,000 of borrowed funds for "consumer purposes" (e.g., to pay off a personal credit card balance), then he would probably want to *not* make any "10T election" where the interest on the loan would end up being treated as nondeductible consumer interest. So, prior to 2018, he would simply take this interest expense as additional mortgage interest on Schedule A. Of course, even prior to 2018, if Gary was in an AMT position, he would instead fall under the "qualified housing interest" (QHI) rules where he would have to "trace" this interest expense based on the "use to which the monies were put" thereby exposing the interest as disallowed "consumer interest" and therefore nondeductible.

☞**Sole Proprietor Uses "Tracing Rules" to Deduct Mortgage Interest on Schedule C (*Pugh*, TC Summ. Op. 2019-2 (2/28/2019))**

The taxpayer was the sole proprietor of a software development company. In 2005 and 2006, he took out a mortgage to purchase two vacant lots that were intended to be the future site of the business's headquarters. However, after losing a major customer, the business sold some of the undeveloped properties. On his 2010 and 2011 income tax returns, using the "tracing rules," the taxpayer deducted mortgage interest on a Schedule C (as opposed to itemizing the interest expense as a deduction on Schedule A). The IRS disallowed the deductions, claiming that (1) the deduction was limited to investment income (which was zero on **Form 4952**) or (2) the expense was "nondeductible personal interest." The Tax Court *disagreed* with the IRS, holding that the properties were allocable (i.e., capable of being traced) to the taxpayer's trade or business. Therefore, the mortgage interest deduction was properly taken into account on Schedule C in computing the taxpayer's AGI. **(Code §163; Mortgage Interest)**

> **Comment: These are the same "tracing rules" which should be used now that the TCJA eliminated the mortgage interest deduction for home equity lines-of-credit if they are *not* used "to build, buy or substantially improve a first or second residence." Under Reg. 1.163-10T(o)(5), an election can be made in the first year that interest is incurred on such debt as *not* having it be treated as secured by the residence in question. The end result is that the**

"tracing rules" are instead employed to trace how the funds were used (as opposed to the "source" of the funds).

☞**Interest on Unrecorded Mortgage Not Deductible (*Defrancis*, TC Summary Opinion 2013-88 (11/6/2013))**

The taxpayers, a married couple, were *not* permitted to take a deduction for the mortgage interest that they paid on a loan from the wife's mother which was used to buy their home. After purchasing a house, the couple subsequently signed a document described as a "mortgage note" promising to pay the wife's mother monthly interest payments plus the full principal amount of $427,333. Nevertheless, the Tax Court agreed with the IRS that the interest was *not* deductible because the loan had never been properly recorded and therefore did *not* meet the requirements to be considered a "secured debt." The Court did dismiss the 20% accuracy-related penalty because they "acted with reasonable cause and made a good-faith effort to properly determine their tax liability." **(Code §163(h); QRI)**

Comment: Although the mortgage note was secured by the home, the mother never recorded the note in order to protect her rights. In other words, if the couple ever sold the home to a buyer who had no knowledge of the loan arrangement, the mother could not enforce its repayment before title to the home was transferred.

Comment: It makes you wonder how the IRS became aware of the couple's deduction for this "mortgage interest." But, there is no question that in order for a mortgage to be considered "qualified acquisition indebtedness," the loan document must be secured by recording the lien against the property at the local court house in the county where the home is located. However, how many young couples borrow from their parents, especially to buy their first home? And, most do *not* even bother to formalize the arrangement by means of a written document, let alone have it recorded. The tax law is clear, though, if the mortgage is *not* recorded by instead treating the associated interest as nondeductible "consumer interest" since it is related to the personal expenditure of buying one's home.

☞**Interest Expense Incurred for Acquisition of Assets Related to Property Settlements in Divorce**

Interest on indebtedness incurred in a property settlement incident to a divorce does *not* have to be characterized as *personal* interest. Instead, it is allocated to the specific assets that the taxpayer is seeking to acquire in the settlement to determine whether it is deductible. (***J.L. Seymour v Commr.*, 109 TC 279, Dec. 52,336 (1997)**) Thus, interest on a promissory note given pursuant to a property settlement was deductible as investment interest when the debt was attributable to the taxpayer's acquisition of his ex-wife's community property share of investment property. (***R.R. Armacost v Commr.*, 75 TCM 2177, Dec. 52,672(M), TC Memo. 1998-150**) And, for example, the interest incurred to buy out the ex-husband's marital interest (i.e., whether he was actually a shareholder or not) in an S corporation would be *trade or business* interest. Furthermore, IRS **Notice 89-35, Sec. IV** would allow this interest to be shown on page 2 of Schedule E. In addition, the interest incurred to buy out his share of the former marital residence would be additional mortgage interest (i.e., qualified residence interest) so long as the debt was secured with a lien recorded at the court house where the title records would otherwise be located. But, with regard to the basis of the assets acquired pursuant to a property settlement, there is no step-up allowed despite the fact that FMV was just paid for these interests. This is because **Code §1041** provides for the tax-free status of property settlements. In other words, the adjusted basis of any assets acquired in a property settlement carries over to the recipient with any additional tax consequences being deferred until such time as the asset is disposed of in a taxable sale or exchange. **(Code §163; Property Settlements)**

Code §164 - Itemized Deduction for State & Local Taxes:

☞**Supreme Court Denies Certiorari of States' SALT Cap Lawsuit** (***New York v. Yellen*, 128 AFTR 2d 2021-6202 (2nd Cir., 2021)**)

The Supreme Court declined to review the 2nd Circuit's decision which held that the **Tax Cuts and Jobs Act's** $10,000 cap on state and local tax (SALT) deductions is constitutional. The suit was filed by the governments of New York, New Jersey, Connecticut, and Maryland. **(Code §164; SALT)**

> **Comment:** Are taxpayers taking advantage of the option to have any state or local taxes paid at the flowthrough entity level?

☞**Final Regs Issued on "SALT Limitation Workarounds" (TD 9907)**

The IRS has issued final regs on "workarounds" whereby taxpayers make contributions to charities in return for state-provided state and local tax (SALT) credits.

Background: Generally, **Code Sec. 170(a)(1)** allows an itemized deduction for any "charitable contribution" paid within the tax year. A "charitable contribution" is a "contribution or gift to or for the use of" entities described in **Code Sec. 170(c)**. Under **Code §170(c)(1)**, such entities include a State, a possession of the United States, or any political subdivision of the foregoing, or the District of Columbia. Under **Code §170(c)(2)** such entities include certain corporations, trusts, or community chests, funds, or foundations, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. Collectively, these are referred to as "Code Sec. 170 entities."

Reg §1.170A-1(c)(5) provides that transfers of property to a **Code Sec. 170** entity that:

1. Bear a "direct relationship to the taxpayer's trade or business," and

2. Are made with a "reasonable expectation of financial return commensurate with the amount of the transfer," may be deducted as trade or business expenses rather than as charitable contributions.

Code §162(a) allows a deduction for all the "ordinary and necessary expenses" paid or incurred during the tax year in carrying on any trade or business. However, under **Code §162(b)** no deduction is allowed under **Code §162(a)** for any contribution or gift that would be allowable as a charitable contribution deduction but for the percentage limitations, the dollar limitations, or the requirements as to the time of payment in **Code §170**. (**Reg §1.162-15(a)(1)**)

Code §164(b)(6), as added by **Sec. 11042(a)** of the **Tax Cuts and Jobs Act** provides that an individual's deduction for SALT paid during a calendar year is limited to $10,000. The $10,000 limit applies to:

1. Real property taxes;

2. Personal property taxes;

3. Income war profits and excess profits taxes; and

4. General sales taxes.

This limitation applies to tax years beginning *after* December 31, 2017, and *before* January 1, 2026. The

$10,000 SALT limit does *not* include foreign taxes or state and local taxes that are paid or accrued in carrying on a trade or business (including rental activities) or an investment activity. In response to the limitation in **Code §164(b)(6)**, some taxpayers have considered tax planning strategies to avoid or mitigate its effects. Some of these strategies rely on SALT credit programs under which states provide tax credits in return for contributions to certain charitable entities, contributions to which are tax deductible under **Code §170**.

In August 2018, the IRS proposed amending **Reg §1.170A-1(h)(3)** to provide, in general, that if a taxpayer makes a payment or transfers property to or for the use of a governmental entity and/or charity and the taxpayer receives (or expects to receive) a SALT credit in return for such payment or transfer, the tax credit constitutes a return benefit to the taxpayer and reduces the taxpayer's charitable contribution deduction.

According to their preamble, the 2018 proposed regs were premised, in part, on the "quid pro quo principle" articulated in **American Bar Endowment, 58 AFTR 2d 86-5190 (S Ct 1986)**, that "a payment of money generally cannot constitute a charitable deduction if the contributor expects a substantial benefit in return." The 2018 proposed regs also proposed amending regs under **Code §642(c)**, to provide a similar rule for payments made by a trust or decedent's estate.

In December 2018, the IRS issued **Rev. Proc. 2019-12**, which provides that, to the extent a C corporation receives or expects to receive a SALT credit in return for a payment to a governmental entity or charity, it is reasonable to conclude that there is a "direct benefit and a reasonable expectation of commensurate financial return" to the C corporation's business in the form of a reduction in the state or local taxes the C corporation would otherwise be required to pay. As a result, the procedure provides a "safe harbor" that allows a C corporation engaged in a trade or business to treat the portion of the payment that is equal to the amount of the credit received or expected to be received as meeting the requirements of an ordinary and necessary business expense under **Code §162**.

In June 2019, the IRS issued **Notice 2019-12** which provides a "safe harbor" under **Code §164** for certain individuals who make a payment to, or for the use of, a governmental entity or charity in return for a SALT credit.

In December 2019, the IRS issued proposed regs under **Code §162**, **Code §164**, and **Code §170** that included the "safe harbors" provided under **Rev. Proc. 2019-12** and **Notice 2019-12**, updated regs under **Code §162** to reflect current law regarding the application of **Code §162** to a taxpayer that makes a payment or transfer to an entity described in **Code §170(c)** for a business purpose, and clarified the application of the "quid pro quo principle" under **Code §170** to benefits received or expected to be received from third parties.

Final Regs: The IRS adopts the 2019 proposed regs with clarifications. The final regs retain the proposed amendments to the regs under **Code §170** to reflect past guidance and case law regarding the application of the "quid pro quo principle" under **Code §170** to a donor who receives or expects to receive benefits from a third party. But, to reflect existing law, the final regs amend the rules in **Reg. §1.170A-1(h)** that address a donor's payments in exchange for consideration. Specifically, the final regs revise **Reg §1.170A-1(h)(4)** to provide definitions of "in consideration for" and "goods and services" for purposes of applying the rules in **Reg. §1.170A-1(h)**. Under the final reg, a taxpayer will be treated as receiving goods and services in consideration for a taxpayer's payment or transfer to an entity described in **Code §170(c)** if, at the time the taxpayer makes the payment or transfer, the taxpayer receives or expects to receive goods or services in return. (**Reg §1.170A-1(h)(4)(I)**)

For additional clarity, the final regs amend the language in **Reg. §1.170A-1(h)(2)(i)(B)** to state that the fair market value of goods and services includes the value of goods and services provided by parties other than the donee. Also, the final regs add a definition of "goods and services" that is the same as the definition in **Reg. §1.170A-13(f)(5)**.

Lastly, the final regs revise the cross-references defining "in consideration for" and "goods and services" in **Reg. §1.170A-1(h)(1)** and **Reg. §1.170A-1(h)(3)(iii)** to be consistent with the definitions provided in **Reg. §1.170A-1(h)(4)**.

Applicability Date: The amendments to **Reg. §1.162-15** apply to payments or transfers made *on or after* December 17, 2019. However, taxpayers may choose to apply the amendments to payments or transfers made *on or after* January 1, 2018. **(Reg. §1.162-15(a)(4))**)

Reg. §1.164-3(j) applies to payments made to **Code §170(c)** entities *on or after* June 11, 2019. However, taxpayers may choose to apply it to payments made to **Code §170(c)** entities after August 27, 2018. (**Reg. §1.164-3(j)(7)**)

The definitions provided in **Reg. §1.170A-1(h)(4)** are applicable to amounts paid or property transferred *on or after* December 17, 2019. (**Reg. §1.170A-1(h)(4)(iii)**) **(Code §170; SALT)**

☞**IRS Regulations on Deductibility of SALT Payments Made by K-1 Entities (IR 2020-252)**

The IRS has announced that it intends to issue proposed regulations to clarify that "specified income tax payments" are deductible by partnerships and S corporations in computing their nonseparately stated income or loss (i.e., as reported in the **K-1, Box 1, "Trade or Business Income"**). Specified income tax payments include amounts paid by a partnership or an S corporation to a state, political subdivision of a state, or the District of Columbia pursuant to a direct imposition of income tax on the entity, without regard to whether the tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit. The proposed regulations will apply to specified income tax payments made *on or after* 11/9/20, but taxpayers may apply the rules to payments made in a tax year ending *after* 12/31/17 and before the date the regulations are published.

> **Comment:** Numerous states now offer small-business owners potential relief from the SALT cap, which limits the federal deduction for state and local taxes on Schedule A of the 1040 to $10,000. For instance, in Conn., La., Md., N.J., Okla., R.I. and Wis., flowthrough entities, such as partnerships, S corporations and LLCs, can elect to instead pay an entity-level tax as opposed to having the owners pay state tax on income that is passed through to them on their K-1s. In turn, the owners then get a state tax break for their pro rata share of tax paid by the firm. In other words, when an election is made, state income tax payments shift from the business owners, who are subject to the federal SALT cap, to the pass-through entities, which are not.

> **Comment:** On a separate note, the IRS has **confirmed** that there is no special break for residents of housing co-ops with regard to deducting state and local taxes. Their share of the co-op's real estate taxes is also subject to the $10,000 cap for federal income tax purposes, no different than the property taxes that homeowners pay.

> **Comment:** Even though this avoids the $10,000 SALT cap, how many partners or S corp shareholders are still itemizing their deductions on Schedule A (i.e., it is estimated that more than 90% of all taxpayers now choose to use the standard deduction). Also, this additional deduction by the partnership or S corporation would otherwise serve to reduce any available "qualified business income" (QBI). **(Code §164; SALT)**

☞**Investment Property Taxes Not Impacted by $10,000 SALT Cap**

The **Tax Cuts and Jobs Act** did *not* affect the taking of investment interest expense otherwise claimed on **Form 4952** and **Schedule A**. Likewise, the TCJA did *not* affect real estate taxes paid, for example, on land held for investment (this is also true of real estate taxes paid on property used in a **Schedule C/F** business, or in a **Schedule E** rental activity.

Code §164(b)(6) expressly exempts state and local taxes paid with respect to "an activity described in **Code §212**" from the $10,000 SALT annual cap. One of the "activities described in **Code §212**" pertains to the "management, conservation, or maintenance of property held for the production of income." **Reg. §1.212-1(b)** states, in part, "Expenses paid or incurred in managing, conserving or maintaining property held for investment may be deductible under **Code §212** even though the property is *not* currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto." Property taxes paid on property "held for the production of income" are expressly deductible under **Code §164** (and, *not* under **Code §212**). Furthermore, **Code §67(b)(2)** expressly excludes taxes deducted under **Code §164** from the definition of "miscellaneous itemized deductions" (which are specifically eliminated for 2018 onward under the **TCJA**).

Example: "Capitalization of Taxes on Raw Land Held for Investment"
A taxpayer holds raw land hoping for future appreciation and its eventual sale at a profit. The local municipality imposes real estate taxes on the land. These taxes are *not* impacted by the SALT cap and, along with otherwise allowable investment interest expense (i.e., as initially calculated on **Form 4952**), can be deducted on **Schedule A**.

Comment: Since real estate taxes (and, interest) are still deductible on **Schedule A** (given that the taxpayer continues to itemized their deductions), the taxpayer can opt instead to capitalize them as "carrying costs" into the basis of the land pursuant to **Code §266**. And, this might make sense if the taxpayer otherwise opts to take the standard deduction instead of itemizing their deductions on **Schedule A**.

☞**State & Local Income Tax Refunds and Tax Benefit Rule After TCJA (Rev. Rul. 2019-11)**

What are the tax ramifications when a client deducts state and local taxes under **Code §164** (i.e., as an itemized deduction on Schedule A) in a prior tax year, and the taxpayer then recovers all or a portion of those taxes in the current tax year? Under the **Code §111** "tax benefit rule," what portion (if any) of the refund must the taxpayer include in their gross income?

Note: There is no longer any talk of Congress raising the SALT limit from $10,000 to $72,500 and making it retroactive.

Comment: What is obviously missing from the IRS examples in this ruling is a fact pattern where the taxpayer "hit the $10,000 SALT cap" *solely* with real estate, sales or personal property taxes. In other words, even though itemizing their deductions, they did *not* list any "state or local *income* taxes" for which they are now receiving a refund. As a result, they arguably did *not* receive any "tax benefit" from this specific type of deduction and, therefore, should *not* have to include any refund of such taxes in their gross income for the following tax year (i.e., similar to where a taxpayers is in an AMT position and receives a state or local income tax refund).

Facts: As illustrated in the four examples below, assumed that the taxpayer is an unmarried individual whose filing status is "single" and who itemized deductions on their federal income tax returns for 2018 in lieu of using their standard deduction of $12,000. The taxpayers did *not* pay or accrue the taxes in carrying on a trade or business (i.e., on Schedules C, E or F) or an activity described in **Code §212** (e.g., holding of raw land). For 2018, the taxpayer was *not* subject to alternative minimum tax (AMT) and was *not* entitled to any credit against income tax. The taxpayer uses the cash receipts and disbursements method of accounting.

Comment: With the elimination of 2% miscellaneous deductions for "investment related expenses" such as real estate taxes on the holding of raw land, to get any tax benefit, the taxpayer would have to capitalize them as a "carrying charge" pursuant to **Code §266** (i.e., which are then added to the land's basis for determining any gain or loss when the investment is eventually sold).

Example #1: Taxpayer A paid real property taxes of $4,000 and state income taxes of $5,000 in 2018. A's state and local tax deduction was *not* limited by **Code §164(b)(6)** because the total amount (i.e., $9,000) was below $10,000. Including other allowable itemized deductions, A claimed a total of $14,000 in itemized deductions on A's 2018 federal income tax return. In 2019, A received a $1,500 state income tax refund due to A's overpayment of state income taxes in 2018.

Example #2: Taxpayer B paid real property taxes of $5,000 and state income taxes of $7,000 in 2018. As a result, **Code §164(b)(6)** limited B's state and local tax deduction on B's 2018 federal income tax return to $10,000, so B could *not* deduct $2,000 of the $12,000 state and local taxes paid. Including other allowable itemized deductions, B claimed a total of $15,000 in itemized deductions on B's 2018 federal income tax return. In 2019, B received a $750 state income tax refund due to B's overpayment of state income taxes in 2018.

Example #3: Taxpayer C paid real property taxes of $5,000 and state income taxes of $6,000 in 2018. As a result, **Code §164(b)(6)** limited C's state and local tax deduction on C's 2018 federal income tax return to $10,000, so C could *not* deduct $1,000 of the $11,000 state and local taxes paid. Including other allowable itemized deductions, C claimed a total of $15,000 in itemized deductions on C's 2018 federal income tax return. In 2019, C received a $1,500 state income tax refund due to C's overpayment of state income taxes in 2018.

Example #4: Taxpayer D paid real property taxes of $4,250 and state income taxes of $6,000 in 2018. As a result, **Code §164(b)(6)** limited D's state and local tax deduction on D's 2018 federal income tax return to $10,000, so D could *not* deduct $250 of the $10,250 state and local taxes paid. Including other allowable itemized deductions, D claimed a total of $12,500 in itemized deductions on D's 2018 federal income tax return. In 2019, D received a $1,000 state income tax refund due to D's overpayment of state income taxes in 2018.

Taxes as an Itemized Deduction: Code §164 generally provides an itemized deduction for certain taxes paid or accrued during the taxable year. Specifically, **Code §164(a)** provides a deduction for: (1) state and local, and foreign, real property taxes; (2) state and local personal property taxes; (3) state and local, and foreign, income, war profits and excess profits taxes; and (4) the generation-skipping transfer tax imposed on income distributions. **Code §164(a)** also provides a deduction for state and local, and foreign, taxes *not* previously described that were paid or accrued within the taxable year in carrying on any trade or business (i.e., on Schedules C, E or F) or an activity described in **Code §212** (i.e., relating to expenses for production of income). **Code §164(b)(5)** allows a taxpayer to elect to deduct state and local general *sales* taxes in lieu of state and local *income* taxes.

The **Tax Cuts and Jobs Act** added **Code §164(b)(6)** which limits an individual's deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). The dollar limitations apply to taxable years beginning *after* December 31, 2017, but they do *not* apply to foreign taxes described in **Code §164(a)(3)** or to any taxes described in **Code §164(a)(1)** and **(2)** that are paid or accrued in carrying on a trade or business or an activity described in **Code §212**.

Code Sec. 111 "Tax Benefit Rule: Code §111(a) excludes from gross income amounts attributable to the recovery during the taxable year of any amount deducted in any prior year to the extent the amount did *not* reduce the amount of tax otherwise imposed upon the taxpayer. **(Cf. Rev. Rul. 93-75)**

Analysis of IRS Examples: If the taxpayers in **Examples #1** through **#4** above "had paid only the proper amount of state and local tax" in the prior taxable year, their itemized deductions may have been lower or they may have instead opted for taking the standard deduction. As a result, the taxpayer in each situation must determine the amount of itemized deductions that the taxpayer would have deducted in the prior year had the taxpayer paid only "the proper amount of tax." The taxpayer must then compare this amount to the total itemized deductions actually taken on the return, or the standard deduction that could have been taken on the return, and include the difference as income on the current year return if the taxpayer received a tax benefit in the prior taxable year from that itemized deduction.

Example #1 - State Income Tax Refund Fully Includible: In 2019, A received a $1,500 refund of state income taxes paid in 2018. Had A paid only the proper amount of state income tax in 2018, A's state and local tax deduction would have been reduced from $9,000 to $7,500 and as a result, A's itemized deductions would have been

reduced from $14,000 to $12,500, a difference of $1,500. A received a "tax benefit" from the overpayment of $1,500 in state income tax in 2018. As a result, A is required to include the *entire* $1,500 state income tax refund in A's gross income in 2019.

Example #2 - State Income Tax Refund Not Includible: In 2019, B received a $750 refund of state income taxes paid in 2018. Had B paid only the "proper amount" of state income tax in 2018, B's state and local tax deduction would have remained the same (i.e., $10,000) and B's itemized deductions would have remained the *same* ($15,000). B received no "tax benefit" from the overpayment of $750 in state income tax in 2018. As a result, B is *not* required to include the $750 state income tax refund in B's gross income in 2019.

Example #3 - State Income Tax Refund Partially Includible: In 2019, C received a $1,500 refund of state income taxes paid in 2018. Had C paid only the "proper amount" of state income tax in 2018, C's state and local tax deduction would have been reduced from $10,000 to $9,500 and as a result, C's itemized deductions would have been

reduced from $15,000 to $14,500, a difference of $500. C received a "tax benefit" from $500 of the overpayment of state income tax in 2018. As a result, C is required to include $500 of C's state income tax refund in C's gross income in 2019.

Example #4 - Standard Deduction: In 2019, D received a $1,000 refund of state income taxes paid in 2018. Had D paid only the "proper amount" of state income tax in 2018, D's state and local tax deduction would have been reduced from $10,000 to $9,250, and, as a result, D's itemized deductions would have been reduced from $12,500 to $11,750, which is less than the standard deduction of $12,000 that D would have taken in 2018. The difference between D's claimed itemized deductions ($12,500) and the standard deduction D could have taken ($12,000) is $500. D received a "tax benefit" from $500 of the overpayment of state income tax in 2018. As a result, D is required to include $500 of D's state income tax refund in D's gross income in 2019.

IRS Ruling: If a taxpayer received a "tax benefit" from deducting state or local taxes in a prior taxable year and the taxpayer recovers all or a portion of those taxes in the current taxable year, the taxpayer must include in gross income the *lesser* of: (1) the difference between the taxpayer's total itemized deductions taken in the prior year and the amount of itemized deductions the taxpayer would have taken in the prior year had the taxpayer paid the "proper amount" of state and local tax or (2) the difference between the taxpayer's itemized deductions taken in the prior year and the standard deduction amount for the prior year, if the taxpayer was *not* precluded from taking the standard deduction in the prior year. **(Code §111; Tax Benefit Rule)**

☞Planning Issues With SALT Deduction Cap Alternatives

Complications - Various Approaches by State: A core issue is how widely varied the different state FTE alternatives are, as well as the fact as to how states treat the different FTE elections offered by other states. For some states where the tax on non-separately stated income K-1 income is paid at the entity level, such income is simply excluded on the owner's personal return. On the other hand, some states treat these taxes paid at the entity level as a credit on the owner's personal return. In Louisiana and Wisconsin, for example, the workaround involves FTEs making an election to be treated as C corporations for state tax purposes. Conversely, in California, FTEs pay a 9.3% levy that owners claim as a credit on their California return.

This lack of uniformity "is what causes the complexity for taxpayers now when trying to figure out whether to elect into this," according to some tax experts. As a result, FTEs doing business in a variety of states while also having owners that reside in a multitude of different states create some unique problems when deciding whether or not to make this election.

Some states may *not* offer a credit for taxes paid in another state, depending on where income is sourced and where the taxpayer resides. Furthermore, some state credits are *not* refundable or have limited carryover provisions. New York, for instance, has released a list of states where it would honor the respective FTE tax, including Ohio's FTE withholding tax on the distributive share of income allocated to nonresident investors that actually predates the TCJA. But, even though Virginia has the very same taxation rates, New York chooses not to honor them.

Where a FTE has owners in different states, whether the entity elects to pay this optional tax is *not* always a straightforward (or, even unanimous) decision, since some taxpayers may be disadvantaged by their state laws while other taxpayers would *not* be.

Comment: The FTE election, from a mathematical standpoint, appears to be most advantageous for this owners in the highest marginal brackets (e.g., 35% or 37%), given they are itemizing their deductions. And, it would get even more complicated if a particular state allowed FTEs to pay an entity-level tax on separately-stated K-1 items as well (currently, the FTE election as stated above, is only on **Box 1** non-separately-stated trade or business income).

Comment: Even if an FTE was on the accrual basis, the IRS guidance in **Notice 2020-75** states that such taxes at the entity level must be "paid" before yearend. In addition, this deduction for state and local taxes paid by the entity will serve to reduce "qualified business income" (QBI) for Sec. 199A 20% deduction purposes. So, the question is (given that the owners all/mostly itemize their deductions) whether it is more beneficial (especially if most of the FTE owners are in the highest marginal brackets) to get this deduction in full on either **Form 1065** or **Form 1120S**, even though they might lose a portion of the Sec. 199A deduction on their personal returns. But, having to report less K-1 income, for instance, on **Schedule E, page 2** will also have the effect of reducing their overall AGI (which is used for a number of other tax breaks).

☞**Nonresident State Income Tax on Law Partner's K-1 Income Not Deductible on Schedule E (*Cutler*, TC Memo 2015-73 (4/9/2015))**

Nonresident state income taxes paid by a lawyer on his law firm's income derived from business that the firm conducted in four other states were *not* allowed to be deducted "for AGI" (i.e., on Schedule E against his K-1 income). Instead, as with any state or local taxes, these taxes are only permitted as itemized deductions on Schedule A.

Background: Under **Code §62(a)(2)**, deductions are allowed "for AGI" if they are "attributable to a trade or business carried on by the taxpayer, if such trade or business does *not* consist of the performance of services by the taxpayer as an employee." **Reg. §1.62-1T(d)** explains this rule to mean that expenses are deductible above the line when they are directly, and *not* merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible for AGI only if they constitute expenses directly attributable to a trade or business or to property from which rents or royalties are derived. As a result, property taxes paid or incurred on real property used in a trade or business are deductible, but state taxes on net income are *not* deductible even though the taxpayer's income is derived from the conduct of a trade or business.

> **Comment:** The result in this case calls into question the argument that state income taxes on *any* K-1 income (i.e., *not* just that derived from out-of-state income sources), which has to be added back as a "preference" for AMT purposes, can also be deducted on Schedule E, page 2 against the K-1 income to which it relates. If the Tax Court feels that state income taxes allocable to K-1 income, in general, cannot be deducted on Schedule E, how can those allocable to the AMT state and local tax addback (i.e., preference) be taken on Schedule E?

On the other hand, certain other deductions, including those for state and local income tax, may be subtracted from AGI in computing taxable income. (**Code §63(a)**, **Code §63(b), Code §63(d), Code §164(a)(3)**)

> **Comment:** "For AGI" deductions generally may be claimed in addition to itemized deductions or the standard deduction and offer the added benefit of reducing AGI, which in turn is used as a measure to limit other tax benefits. By contrast, below-the-line deductions are subject to income limitations (i.e., phaseout mechanisms) and in some instances can be deducted only to the extent they exceed a specified threshold amount.

Facts: The taxpayer was a partner in a law firm which was organized in Michigan but which also derived income from sources in Missouri, Virginia, Illinois, and Oregon. And, even though the taxpayer did *not* perform any services for clients in those other states, he was still require to paid nonresident state income taxes on firm's income from those states. All of the income was listed in both Box 1 and Box 14 of his K-1 as "trade or business income" subject to S/E tax. He then reported this income and claimed deductions for all nonresident state income taxes as "unreimbursed partnership expenses" on Schedules E. These deductions amounted to $11,943 in 2007, $15,104 in 2008, and $14,832 in 2009. But, the Tax Court agreed with the IRS that state and local taxes (including those paid to another state) in this instance could only be claimed as itemized deductions on his Schedule A (thereby increasing his AGI, with associated increases in self-employment tax and alternative minimum taxable income). **(Code §164; State Income Taxes)**

☞**Housing Co-op Real Estate Taxes Subject to $10,000 SALT Cap (CCA 2020-0010)**

Residents of housing co-ops are subject to the same limitation on deducting state and local taxes. As a result, their share of the co-op's real estate taxes is subject to the $10,000 cap for federal income tax purposes, similar to the property taxes that homeowners pay. **(Code §164; SALT Cap)**

☞**Itemized Deductions Paid on Behalf of Taxpayer Treated as Deemed Gifts and Allowed on Schedule A (*Judith Lang*, TC Memo 2010-286 (12/30/2010))**

In a case which seems to go against a principal that we have espoused for years to our clients, the Tax Court has held that the deductibility of medical expenses and real estate taxes should nevertheless be allowed to a taxpayer on Schedule A even that they were instead paid directly to medical providers and the taxing authority by her mother. The taxpayer was *not* a minor, and her mother was *not* legally obligated to pay the expenses. Yet, the Tax Court refuted the IRS's contention that the expenses were *not* deductible to the taxpayer because she had *not* personally paid the expenses. Each of the expenses was viewed as a "deemed gift" that had been made to the taxpayer which she then used to pay her liabilities. Furthermore, gift taxes did *not* apply since the medical payments were "qualified transfers" under **Code §2503** and the real estate taxes were below the annual exclusion otherwise applicable for the tax year in question. **(Code §§164 & 213; Itemized Deductions)**

> **Comment:** This is one of those instances that "substance over form" controlled the outcome. The IRS had insisted that the "form" of the transaction was that the mother had paid the outstanding liabilities, though she was not legally liable for them. Therefore, the taxpayer should not be considered to have "paid" them for tax purposes.
>
> **Comment:** The gift tax regs identify indirect gifts, such as payments made to a third party on behalf of a donee, as a "transfer" to the donee. (**Reg. §§ 25.2511-1(a), (c)(1), (h)(2) and (3)**). Furthermore, the Tax Court noted that there is no danger of a "double deduction" in this case. (Cf. **Rome I, Ltd. v. Commr., 96 T.C. 697, 704 (1991)** which stated that "double deductions are impermissible * * * absent a clear declaration of intent of Congress.". And, because the real estate tax was imposed upon the taxpayer here, she was the only one who would be permitted to deduct it (i.e., the taxpayer's mother would never be allowed the deduction) (Cf. **Reg. §1.164-1(a)**)
>
> **Comment:** Another example of this situation came out recently when the IRS recognized that the payment of student loan interest by a parent, for instance, was deemed to be made on behalf of the child and therefore they were able to take up to $2,500 as a deduction for AGI. Note, that if the parent was a guarantor or co-signer on the loan, they could have instead taken this deduction, so long as the child was no longer a dependent.

Code §165 - Losses:

☞**Large Bad Debt Deductions Recharacterized as Capital Contribution Losses (*Allen*, TC Memo. 2023-86 (7/11/2023))**

A real estate developer attempted to claim large bad-debt deductions on pass-through entities owned directly and indirectly by the taxpayer. He had advanced millions of dollars in funds to these related companies in the early 2000s. When the real estate market went into a severe recession, the developer insisted that these losses were flow-through *business* bad-debt deductions (i.e., ordinary losses). The IRS disallowed the write-off with the Tax Court agreeing that the advances were in fact equity contributions and *not* loans (i.e., therefore, "nonbusiness bad debts" which are treated as STCLs). Even though written promissory notes were issued, the Court gave more merit to other factors, noting that special scrutiny was warranted because of these related-party transactions. The "borrowers" here did *not* go through the normal process for borrowing money had they attempted to seek a loan from unrelated third-party lenders. Moreover, the entities involved did not *have* sufficient earnings to repay the advances.

(**Code §165**; **Related-party Loans**)

☞**Beware of "Wash Sale" Rules**

With the recent downturn in the market, it might make sense to sell off some of your losing stocks and offset the losses on any appreciated securities that you might otherwise be considering selling. Nevertheless, you have to keep in mind the "wash-sale rule." If you purchase "substantially identical securities" up to 30 days *before or after* the sale, the capital loss is *not* deductible. Instead, any suspended loss is added to the tax basis of the replacement securities. And, the wash-sale rule can apply when you're not expecting it. For example, this rule would apply if you buy stock in an IRA (or, you 401(k) or 403(b) plan) after selling the same stock or at a loss in your taxable investment account, or if you sell a mutual fund at a loss 25 days after the date a dividend is reinvested.

Example: You buy 100 shares of Y stock for $1,000. You sell these shares for $650 and within 30 days of the date you sold the shares, you purchase 100 shares of the same Y stock for $900. Since you bought stock that was substantially identical, you cannot deduct the loss of $350 on the sale. You will need to add this disallowed loss to the basis of the new stock that you purchased for $900, therefore your new cost basis in this stock will be $1,250.

What securities are included in this rule? The IRC states that the following securities are subject to the wash-sale rules: (1) Corporate stock; (2) Bonds; (3) Mutual funds; (4) Exchange-traded funds (ETFs); (5) Options and futures contracts; and (6) Common stock warrants.

Comment: Remember, though, that the rule does *not* apply to trades made completely within an IRA. For instance, it would be fine if you sell securities in your IRA at a loss and buy them back in the IRA within 30 days.

Comment: Recent volatility has investors considering selling off stocks that are losing value each day and buying them back when they have "bottomed-out." This strategy would, theoretically, allow you to harvest tax losses while purchasing the stock back at a lower price in the expectation that the stock can return to, and possibly surpass, its previous value. But, again, the "wash sale" rule would prevent these losses from being claimed.

Comment: Surprisingly, the IRS treats cryptocurrency as "property," therefore excluding it from the wash sale rules.

Who does this rule apply to? The wash sale rules apply to taxpayers and their spouses, as well as any corporation that either the taxpayer or spouse directly (or, indirectly) controls. As mentioned above, this rule also applies to individual retirement accounts (i.e., you sell at a loss out of your taxable investment account and then buy back the same investment with your IRA) . Also, you cannot circumvent this rule by selling the stock at a loss in your portfolio and having your spouse purchase the stock in theirs within the 30-day time frame.

How do you know if you're purchasing a "substantially identical" security? As with a great deal of the IRC, there is considerable ambiguity surrounding the term "substantially identical." As a result, taxpayers must rely on case law, Revenue Rulings, and their own interpretations of the IRC, to make this determination. The closest form of guidance we have is in **IRS Pub. 550**, where the IRS states:

"In determining whether stock or securities are 'substantially identical,' you must consider all the facts and circumstances in your particular case. Ordinarily, stocks or securities of one corporation are *not* considered substantially identical to stocks or securities of another corporation."

What about mutual funds and ETFs? The IRS has *not* addressed these types of investments specifically, but published guidance indicates that mutual funds or ETFs are "substantially identical when they have similar proportions of underlying securities or are managed in a similar fashion." **(Code §165; Wash Sale Rules)**

☞IRS Special Mailings to Taxpayers in Certain Disaster Areas (IR 2023-121)

The IRS is sending a special follow-up mailing, known as a **CP14CL**, to taxpayers in several states affected by disasters to let them know that they have additional time to pay their taxes. The IRS "is taking this additional step to help reassure taxpayers affected by disasters that they do have extra time to file and pay their taxes." This new mailing is going to residents in Alabama, Arkansas, California, Florida, Georgia, Indiana, Mississippi, and Tennessee in designated disaster areas that received a **CP14 notice** from the IRS in late May and June. The **CP14** mailings are for taxpayers who have a balance due, and they are sent out as a legal requirement.

Comment: While the notice received by taxpayers says they need to pay in 21 days, these taxpayers actually have until later this year to timely pay under the disaster declaration.

Comment: It should be noted that if a taxpayer suffers a "qualified casualty loss," they can take that loss as a "for-AGI" deduction (i.e., in addition to their otherwise allowable standard deduction). Such casualty losses do *not* need to exceed 10% of adjusted gross income to qualify for the deduction, but you would need to reduce each casualty loss by $500 after any salvage value and any other reimbursement. On the other hand, if the PDDA (presidentially declared disaster area) is *not* "qualified," the instructions to **Form 4684** indicate that such casualty losses can only be claimed as an itemized deduction on **Schedule A** (i.e., subject to the 10% of AGI threshold and $100 per event limits).

☞Rebuilding Records After Natural Disasters

Tax records are not a first priority for those affected by natural disasters nor should they be. However, these records may be necessary to get federal assistance or insurance reimbursement. It is important for victims of a disaster to reconstruct their records to help prove and document their losses.

Based on a recent IRS **"Tax Tip,"** here are some steps that the Service is recommending to help people reconstruct important records they may need as they begin to recover and rebuild.

Tax Records: Taxpayers can get free tax return transcripts immediately using **Get Transcript** on IRS website. As an alternative, tax transcripts can be ordered by calling 800-908-9946 and following the prompts.

Financial Statements: Individuals can gather past statements from their credit card company or bank. These records may be available online. People can also contact their bank to get paper copies of these statements.

Property records: Homeowners can get documents related to property by contacting the title company, escrow company or bank that handled the purchase of their home or other property. Taxpayers who made home improvements can get in touch with the contractors who did the work and ask for statements to verify the work and cost. They can also get written descriptions from friends and relatives who saw the house before and after any improvements. For those individuals who inherited property, they can check court records for probate values. If a trust or estate existed, taxpayers can contact the attorney who handled the trust. Individuals with no records available should check the county assessor's office for old records that might address the value of the property. Car owners can research the current FMV for most vehicles. Resources are available online and at most libraries. These include **Kelley's Blue Book**, the **National Automobile Dealers Association** and **Edmunds**. **(Misc.; Tax Records)**

Additional Information: Further IRS guidance can be gleaned from the following sources: (1) **IRS Pub. 547, Casualties, Disasters, and Thefts**; (2) **IRS Pub. 584, Casualty, Disaster, and Theft Loss Workbook**; (3) **IRS Pub. 584-B, Business Casualty, Disaster, and Theft Loss Workbook**; (4) **IRS Pub. 976, Disaster Relief**; (5) **Small Business Administration**; and (6) **DisasterAssistance**. **(Misc.; Disaster Relief)**

☞IRS "Fact Sheet" Offers Guidance re: Reconstruction of Tax Records After Disaster Strikes (Fact Sheet 2018-18)

The IRS published a "fact sheet" discussing the challenges encountered by taxpayers when reconstructing their financial records in the aftermath of a disaster. Reconstructing such records soon after a disaster "may be essential for properly documenting a tax-deductible loss, supporting various tax-related transactions, or getting federal assistance or insurance reimbursement," the IRS noted. "The more accurately the loss is estimated, the more loan and grant money there may be available," the agency added. The fact sheet lays out "simple steps" that can help taxpayers. The first addresses tax records: free return transcripts are immediately available by using the **Get Transcript** tool on the IRS website; transcripts can be ordered by phone; transcripts of returns from previous years can be ordered by mail using **Form 4506-T, Request for Transcript of a Tax Return**; copies of past returns can be ordered by mail using **Form 4506, Request for Copy of Tax Return**; and writing the appropriate disaster designation in red letters across the top of the forms to expedite processing and to waive the user fee.

The second topic deals with personal residence and real property: take photographs and/or videos as soon as possible following the disaster; contact the title company, escrow company or bank that handled the home purchase to obtain copies of appropriate documents; use a current property tax statement for land-versus-building ratios (also available from county assessor's office); establish a basis or fair market value of the home by viewing comparable sales within the same neighborhood; check with mortgage company for documents regarding cost or fair market value; review insurance policies for pertinent information; and if improvements were made to the home, contact contractors used and request any information they may have.

The Service also recommended the following resources that can help in determining the current fair market value of most cars: **Kelley's Blue Book**, the **National Automobile Dealers Association**, and **Edmunds**. In addition, the dealer where the car was purchased usually is able to provide a copy of the sale contract. With regard to personal property, "It can be difficult to reconstruct records showing the fair market value of some types of personal property." But, the IRS in this "Fact Sheet" offered a number of "pointers to consider" when cataloging lost items and their values: (1) check mobile phones for photos taken in the home that might show the damaged property; (2) check websites that can help establish the cost and fair market value of lost items; (3) gather supporting documents, which can include photos, videos, canceled checks and receipts; and (4) if items were purchased with a credit card or debit card, obtain past statements from credit card companies and banks. **(Misc.; Tax Records)**

☞Claiming PDDA Personal Casualty Losses While Taking Standard Deduction & Related Special Tax Breaks for Casualty Situations

According to the **Instructions** to the 2021 version of **Form 4684**, taxpayers can increase their otherwise allowable standard deduction by following these reporting steps:

Comment: Note that only "qualified disaster losses" may be treated as a for-AGI deduction (i.e., you do not have to be itemizing your deductions on **Schedule A**). Otherwise, the loss would have to be itemized, subject to the $100 threshold and 10% of AGI limit.

Comment: Other personal losses such as those stemming from theft or embezzlement are no longer deductible after the **TCJA**.

1. Enter the amount from **Form 4684, line 15**, on the dotted line next to **line 16** on **Schedule A** and the description, **"Net Qualified Disaster Loss."**

2. Also, enter on the dotted line next to **line 16** of **Schedule A**, your standard deduction amount and the description, **"Standard Deduction Claimed With Qualified Disaster Loss."**

3. Combine these two amounts and enter the total in the entry space on **line 16** of **Schedule A** and on **Form 1040** or **1040-SR**, **line 12a**.

Personal Casualty Loss Deduction: As mentioned above, individuals can deduct personal "qualified disaster losses" even if they do *not* itemize. Uninsured personal losses in excess of a $500 threshold are allowed without regard to the 10%-of-AGI threshold that generally applies. This net loss is treated as an "additional standard deduction" for non-itemizers. The instructions to **Form 1040, line 9** and **Schedule A, line 16** provide additional details on how to report this write-off on one's personal return. Also, **Program Manager's Tax Advice (PMTA) 2019-08** contains a detailed description of this special tax break.

☞**IRS Offers Guidance on Scope of New Personal Casualty Loss Limitation (PTMA 2019-008)**
The **Tax Cuts and Jobs Act (TCJA)** added **Code §165(h)(5)** which now limits individual (i.e., **Schedule A** personal) casualty losses to only those attributable to a "presidentially declared disaster area."

Comment: Casualty losses with regard to other property such as **Schedule C**, **E** and **F** continue to be claimed *with no change* occurring due to the TCJA. But, non-PDDA losses (e.g., uninsured loss where home burns down or a theft loss) are no longer deductible, even if the taxpayer does in fact itemized their deductions on **Schedule A**.

Background: Generally, for tax years before 2018, a loss sustained during a tax year, and *not* compensated by insurance or otherwise, could be deducted under **Code §165(a)** if such loss arose from fire, storm, shipwreck or other casualty (i.e., casualty losses) or from theft (i.e., theft losses). The TCJA added **Code §165(h)(5)(A)**, which provides that, for tax years *after* 2017 and *before* 2026, individual (i.e., personal) casualty losses are only deductible to the extent they are attributable to a "Federally declared disaster." A Federally declared disaster is any disaster subsequently determined by the president to warrant assistance by the Federal government under the Stafford Act. (**Code §165(i)(5)(A)**) Furthermore, a loss occurring in a disaster area and attributable to a Federally declared disaster may, at the election of the taxpayer, be deducted for the tax year *immediately preceding* the tax year in which the disaster occurred. (**Code §165(i)(1)**)

Comment: After a Federal disaster is declared for a state, areas eligible for assistance (disaster areas) are identified by county within the affected state.

To be allowed as a casualty loss deduction, a loss "must be evidenced by closed and completed transactions and fixed by identifiable events sustained during the tax year." (**Reg. §1.165-1(b)**) A casualty loss is *not* considered to have been "sustained" when there exists a claim for reimbursement "for which there is a reasonable prospect of recovery" until it "can be ascertained with reasonable certainty" whether such reimbursement will be received. (**Reg. §1.165-1(d)(2)(I)**)

New TCJA Casualty Loss Limitation: This PTMA provides two examples of how new **Code §165(h)(5)** works to limit individual casualty losses.

Example #1: In the first example, A's home in Kansas was damaged in 2017 by a flood that was *not* a "Federally declared disaster." A filed a claim with his insurance for the entire loss and had a reasonable prospect of recovering the entire amount claimed. In 2018, A received 70% of the claimed amount from his insurance and it became reasonably certain that A would *not* recover the other 30% of his claim. As a result, in 2018, A sustained an individual casualty loss equal to 30% of the total flood damage that occurred in 2017. However, A's individual casualty loss was *not* deductible under **Code §165(h)(5)** because it was *not* attributable to a Federally declared disaster and was considered "sustained" in 2018 (i.e., the year in which the claim was settled with the insurance company and became final with no prospect of recovering the other 30% due to the loss).

Example #2: In the second example, with the same facts as above, A's flood damage in 2017 occurred during a storm for which the president issued a Federal disaster declaration for Kansas under the Stafford Act. Nevertheless, A's home was *not* located in one of the counties designated as eligible for assistance. According to the PMTA, A could claim an individual casualty loss deduction, even though his home was *not* in one of the designated counties, because **Code §165(h)(5)** does *not* require the loss to occur in a disaster area. In other words, it only requires the loss to be "attributable to a Federally declared disaster." Therefore, as long as A's home was in a state that received a Federal disaster declaration and his loss was attributable to that disaster, A was eligible to claim an individual casualty loss deduction in 2018 for the 30% he did *not* recover from his insurance claim. (**Code §165; Casualty Losses)**

☞IRS Offers Safe Harbors for Calculating Personal Casualty Losses (Rev. Proc. 2018-08)

For taxpayers who might have suffered casualty or theft losses to their home or personal belongings, the IRS has now released multiple safe harbors when calculating such losses. One approach allows a homeowner with casualty losses of $20,000 or less take the *lesser* of two repair estimates to determine the decrease in the home's value (i.e., from its pre-casualty condition). Another approach utilizes an IRS table to compute the replacement cost of personal belongings destroyed in a presidentially declared disaster area (PDDA). (**Code §165; Casualty Losses)**

Comment: For those victims of hurricanes, another safe harbor is being provided by the IRS. These taxpayers are permitted to use "cost index tables" to determine the amount of loss to their residences. There are separate tables for various categories of home damage, ranging from total loss to over one foot of interior flooding to a ruined deck. **Rev. Proc. 2018-09** can be referenced for additional details.

Comment: Keep in mind that the **TCJA** repealed the write-off for personal casualty and theft losses beginning in 2018, except for casualty losses in presidentially declared disaster areas.

☞Intra-Family Loan Comes Under Close Scrutiny by IRS (*VHC, Inc.*, Nos. 18-3717 & 18-3718 (7th Cir., 8/6/2020))

A company advanced millions of dollars to the founder's son. Even though the payments were evidenced by promissory notes with fixed maturity dates, many notes did *not* have original signatures. And, the firm had no way to enforce repayment and routinely deferred payment. Moreover, it continued to advance funds to the son even after he failed to repay amounts that were overdue. The Tax Court, in a 2017 decision, confirmed there was no bona fide debt and denied the company's bad-debt deductions (i.e., as STCLs). The 7th Circuit has now affirmed that decision meaning that basically these were deemed distributions (or, dividends) to the father who owned VHC, Inc. and who then made these "gifts" to his son. (**Code §165**; **Bad Debts)**

Code §170 - Charitable Contributions:

☞**IRS Issues Warning to Taxpayers of Improper Art Donation Deduction Promotions (IR-2023-185)** The IRS is warning taxpayers to be wary of promotions involving exaggerated art donation deductions that can attract high-income filers, while also offering special tips for people to use to avoid getting caught in such schemes. As part of a larger effort to increase compliance work on high-income individuals and corporations, and protect taxpayers from scams, the IRS has active promoter investigations and taxpayer audits underway in this area.

How Scheme Works: Promoters try to encourage taxpayers to buy various types of art, often at a "discounted" price. This price may also include additional services from the promoter, such as storage, shipping and arranging the appraisal and donation of the art. The promoter then promises that the art is worth significantly more than the purchase price and that purchasers should wait at least a year to claim a highly-inflated FMV upon donating the items. Promoters may even arrange for certain charities to take the donations.

> **Comment:** These donations can involve art valued at millions of dollars. And, at this point, the Service has completed more than 60 taxpayer audits with additional ones in progress resulting in more than $5 million in tax collected.

Questionable Tactics: Taxpayers should be wary of buying multiple works by the same artist that have little to no market value outside of what the promoter might be advertising. Another "red flag" in this scheme is that promoters might line up specific appraisers for participants to use. An appraisal that supports this scheme often fails to adequately describe the art. It may not address the value characteristics, such as rarity, age, quality, condition, stature of the artist, price paid and the quantity purchased.

Substantiating Charitable Deductions of Art: To properly claim a charitable contribution deduction for an art donation, a taxpayer must keep records to prove: (1) Name and address of the charitable organization that received the art; (2) Date and location of the contribution; and (3) Detailed description of the donated art. In addition, the following filing requirements must be met: (1) If the claimed deduction for an art donation is **$250 or more**, the taxpayer must obtain a **"contemporaneous written acknowledgment"(CWA)** of the contribution from the charitable organization on or before the *earlier* of the date on which they file a return for the taxable year in which they made the contribution, or the due date, including extensions, for filing such return; (2) If the claimed deduction for an art donation is **more than $500 but not over $5,000**, the taxpayer must also complete a **Form 8283, Noncash Charitable Contribution, Section A**, and include the details of each donated item; or (3) If the claimed deduction for an art donation is **$20,000 or more**, the taxpayer must meet all of the above requirements while also attaching a complete copy of the "qualified appraisal" to their return. In addition, they should also have a "high-resolution photo or digital image of the object" and provide it, if asked by the IRS.

> **Comment: IRS Pub. 561 "Determining the Value of Donated Property"** contains detailed coverage of these requirements including what constitutes a "qualified appraisal." The IRS also has a team of professionally trained **Appraisers in Art Appraisal Services** who provide assistance and advice to the IRS and taxpayers on valuation questions in connection with

personal property and works of art.

☞**Contemporaneous Written Acknowledgment Needed for Charitable Deduction (*Albrecht*, TC Memo. 2022-53 (5/25/2022))**

It is critical that taxpayers adhere to the substantiation rules to secure a charitable deduction. One of the most important requirements is to obtain a contemporaneous written acknowledgment (CWA) from the charitable donee for gifts of $250 or more, while also filing **Form 8283** for noncash donations over $500. In addition, *written* appraisals (specifically stating that they are for income tax purposes) are needed for property gifts (except publically traded securities) valued at over $5,000. Failing to strictly comply with these rules could result in the complete lost of the charitable deduction, as illustrated in this case. Here, the taxpayer donated jewelry and artifacts to a museum. The parties signed a deed of gift that listed the donated items and she claimed a corresponding charitable deduction on Schedule A. But, **Form 8283** with an written appraisal was *not* included with her return. She only attached the gift deed to her return. The Tax Court disallowed her write-off because the deed of gift could *not* be treated as the equivalent of a CWA. The critical missing element was that the gift deed *not* state whether the museum "provided any goods or services in exchange for her gift." **(Code §170; Form 8283)**

> **Comment:** The CWA must be obtained from the charity by the *earlier* of: (1) Date the return actually filed; or (2) The extended due date of the return.

☞**Tax Ramifications of Donating Annuity Contract to Charity**

There are some potential tax issues on such donations, including deemed gain on transfer of the contract. Donors will generally be treated as receiving taxable income equal to the difference between the annuity's cash surrender value and their investment in the contract. For instance, an individual has purchased an annuity contract some years ago for $10,000 that is now worth $30,000. If the contract was donated to a charity, there would be a deemed gain of $20,000 to be included in gross income in the year of the transfer. Furthermore, there might also be a 10% penalty on early distributions if the taxpayer was under 59½. As far as the charitable contribution deduction of $30,000, it would have to be listed as an itemized deduction on Schedule A. **(Code §170; Annuity Contracts)**

> **Comment:** Taxpayers who instead claim the standard deduction would have to pick up this deemed gain while *not* having the offset of a charitable contribution.

☞**Qualified Appraisal Required to Deduct Charitable Contribution of Cryptocurrency (CCA 202302012)**

Code §170(f) normally requires that a taxpayer satisfy certain substantiation requirements (i.e., on **Form 8283**) in order to claim a charitable contribution deduction for non-cash donations. In this instance, the IRS disallowed a taxpayer's charitable contribution deduction for a donation of more than $5,000 in cryptocurrency because she failed to obtain a "qualified appraisal" of the donated property. Relying on the cryptocurrency exchange's value of the donated cryptocurrency did *not* meet the "reasonable cause exception" for a failure to obtain an appraisal. A qualified appraisal was needed because the taxpayer donated property with a value of more than $5,000. Also, the donated property was *not* exempt from the qualified appraisal requirement because it was *not* one of the types of property listed as exempt in the regulations (i.e., such as publicly traded stock or securities). Therefore, the entire deduction for the gift was disallowed. **(Code §170; Cryptocurrency)**

> **Comment:** Keep in mind that the requirements for a charitable contribution deduction such as a "contemporaneous written acknowledgment" (CWA) that no "good or services" were received in return for the donation, or that a "qualified appraisal" might be needed for a non-cash donation, have to be satisfied by the due date (including extensions) for filing the return. As can be seen in

cases such as this, you cannot go back after the due date of the return to get this needed information.

☞**Donor Has No Standing to Sue Donor-advised Fund (*Pinkert v. Schwab Charitable Fund*, No. 20-cv-07657-LB (N.D. Cal. 6/17/21))**

A person who donated to a donor-advised fund managed by Charles Schwab & Co.was found to *not* have standing to sue the fund's sponsor for breach of fiduciary duty with respect to the assets the donor contributed to the fund. The court found that by making an irrevocable contribution of the assets to the fund in exchange for an immediate charitable contribution tax deduction, the donor relinquished control of the assets and therefore "did *not* suffer a concrete injury from the conduct of the sponsor that he challenged," which would support standing to sue under Article III of the U.S. Constitution and California law.

Background: Schwab Charitable Fund (SCF) sponsors a donor-advised fund. A donor-advised fund is defined in **Code §4966(d)(2)(A)** as: A fund or account (i) which is separately identified by reference to contributions of a donor or donors, (ii) which is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor has "advisory privileges" with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

When a donor contributes to a donor-advised fund, the not-for-profit sponsor of the fund takes legal title to the assets. The sponsor of the fund holds a donor's contributions in separately identified accounts, and donors can direct how the funds are invested (i.e., from specified investment options offered by the fund) and ultimately distributed to charitable organizations.

A donor to a donor-advised fund is permitted to claim a tax deduction for a charitable donation made to the fund if they make a "completed gift" and "relinquish dominion and control over the donated property" (**Code §§170(a), (c),** and **(f)(18)**; ***Viralam*, 136 T.C. 151, 162 (2/14/2011)**). The fund, in other words, must have "exclusive legal control" over the donated assets. As a result, while the fund will take recommendations from the donor about the investment and distribution of the donated assets, the fund is *not* required to follow those recommendations. In the case of the fund sponsored by SCF, when a donor makes a contribution, SCF informs the donor in a contemporaneous written document that the fund has assumed exclusive legal control over the assets contributed, allowing the donor to claim a charitable contribution deduction for the contribution.

The investment options available in the fund are selected by SCF's board of directors and investment oversight board, and there are 14 investment options of various types available in this particular instance. Donors can make non-binding recommendations about how the money they contribute is invested in these investment options. Meanwhile, SCF employs Charles Schwab & Co. to provide custodial and brokerage services to the donor-advised fund.

Facts: The taxpayer was a donor to SCF. But, he "became disenchanted with the way SCF was running the donor-advised funds," objecting to SCF's choice of certain investment options (e.g., where funds of the same type that charged *lower* fees were available) and the payment of what he believed were excessive fees for custodial and brokerage services to Charles Schwab. He alleged that there were cheaper investment options available than those chosen by SCF and that SCF could have used its market power to obtain better rates from Charles Schwab for its custodial and brokerage services. He also alleged that SCF's actions were causing the funds to incur excess expenses, which were diminishing the amount of his donations that were ultimately distributed to the charitable donees he chose.

The taxpayer sued SCF for breach of fiduciary duty, Charles Schwab for aiding and abetting the breach of fiduciary duty, and both defendants for violating **California's Unfair Competition Law** by their acts. In response, SCF and Charles Schwab made a "motion to dismiss for lack of standing." The defendants claimed that by making an irrevocable contribution to the fund in exchange for an immediate charitable tax deduction under **Code §170**, the taxpayer relinquished control of his assets. As a result, he did *not* "suffer a concrete injury from the defendants' conduct" that he challenged, and therefore lacked standing to sue under Article III of the Constitution.

District Court Decision: The court agreed with the defendants that since the taxpayer had given up title to and control of his donated assets in order to get an immediate tax deduction, the donor-advised fund controlled the donated assets and the taxpayer "could no longer be injured by what happened to the donated assets." Even though he did *not* control the donated assets, the taxpayer contended he had standing because he advised the fund on their investment and directed how the donated assets were distributed to charities, the excess administrative fees reduced the value of his donated assets, and his reputation suffered because of the reduced funds available to be distributed to charitable organizations. **(Code §170; Donor-advised Funds)**

> **Comment:** Taxpayers who would benefit from increasing deductions in a particular year (e.g., "double up" on charitable contributions every other year v. taking the standard deduction) are often encouraged to make contributions to donor-advised funds. This allows an immediate deduction for a charitable contribution of assets without having to actually distribute the funds to charity until later years. However, as this case demonstrates, while the donor may make recommendations to the fund about the donated assets, the fund is generally *not* bound to follow them, either with respect to how the funds are invested or to whom they are ultimately distributed. If the donor believes that a fund is *not* being a proper steward of the donated assets, there may be little or nothing the donor can do about it. As a result, donors should be very careful in choosing a donor-advised fund.

☞Donation of Less than Entire Interest in Home Nixed Deduction (*Mann*, No. 19-1793 (4th Cir., 1/6/21))

The taxpayers in this instance allowed a charity to "deconstruct" their house. When they purchased the residence, they did so with the intention of demolishing the existing structure and building a new home. They ended up conveying the structure to a nonprofit organization that hired disadvantaged people to deconstruct buildings and salvage the materials. However, neither the couple nor the charity recorded the transaction in the state's land records. The couple then attempted to take a charitable deduction for the house's full value. A district court denied the write-off, agreeing with the IRS that the couple failed to transfer their "entire real property interest" which precludes claiming *any* tax deduction for the donation. The couple appealed the lower court's decision, but the 4th Circuit upheld the decision. **(Code §170; Charitable Contributions)**

> **Comment:** This type of analysis would also apply where the taxpayer donated the structure to the local fire department for a "controlled burn" but nevertheless retained title to the land (usually to build a new structure thereon).

☞Redemption of Donated Stock After Transfer to Charity Allowed (*Dickinson*, TC Memo. 2020-128 (9/3/2020))

The chief financial officer of a privately-held corporation donated shares that he owned in the company to a charitable fund. The charity then sold the stock back to the company after receiving the shares (i.e., as part of a redemption). Upon review, the IRS insisted that the transaction should instead be treated as a sale of stock by the CFO followed by a donation of cash. The Tax Court rejected this assertion and concluded that the form of the transaction should be respected because the CFO absolutely transferred all of his rights in the stock to the charity, and the redemption "was *not* a done deal on the date of the charitable contribution." As a result, the CFO avoided having to recognize a significant capital gain. **(Code §170; Stock Donations)**

> **Comment:** So, he avoids the capital gain that would have been associated with the sale of the stock, gets a charitable deduction equal to the FMV as of the time of the gift and the charity gets the cash flow from selling the stock back to his corporation, while he remains the sole owner of the company based on the shares outstanding. Not a bad planning strategy, but how "old-and-cold" does the charitable donation of the shares have to be so as not to be connected with the subsequent buyback by the corporation?

☞**Overvaluation of Conservation Easements (*Murfram Enterprises LLC*, TC Memo. 2023-73 (6/15/2023) and *Murphy*, TC Memo. 2023-72 (6/15/2023))**

A pig farmer was able to sustain the valuation for one of easement donation valuation disputes, but the other two were found to be overvalued. The taxpayer and his family-owned entities donated three conservation easements to a charitable land trust. One of the easements was on rural undeveloped land, and the other two were on developed land. The IRS challenged the value of these donations. The Tax Court agreed that the valuation of the rural land easement (i.e., as shown on **Form 8283**) was "mostly accurate," but greatly reduced the value of the other two easements. **(Code §170; Conversation Easements)**

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> **Comment:** These cases provide a good overview of how the valuation of a conservation easement should be approached and substantiated in order for it to be allowed for charitable deduction purposes.

☞**Sample Conservation Easement Language (CCA 202130014)**

The IRS has provided sample conservation easement deed language that, according to the IRS, will generally *not* cause a deed to violate the "enforceability in perpetuity" requirements of **Code §170(h)(2)(C)** and **Code §170(h)(5)(A)**.

Background: A taxpayer may be allowed a charitable contribution deduction for granting a conservation easement if the easement meets various requirements under **Code §170(h)**. Among other things, for the value of a conservation easement to be deductible, the property interest "must be granted in perpetuity" under **Code §170(h)(2)(C)** and "enforceable in perpetuity" under **Code §170(h)(5)(A)**. Up to this point, donors have been denied a charitable deduction when the deed granting a conservation easement contains language that violates these perpetuity rules upon the easement's extinguishment.

As clarified by this CCA, a conservation easement fails to satisfy the requirements of **Code §170(h)** if the deed contains language "subtracting from the donee's extinguishment proceeds the value of post-donation improvements or the post-donation increase in value of the property attributable to improvements."

Suggested Sample Language: The CCA is now advising that "language in a conservation easement deed that closely adheres to the language of **Reg. §1.170A-14(g)(6)(ii)** generally will *not* cause a deed to violate [those two perpetuity requirements]." The CCA recommends that donors to "see the following sample conservation easement deed language:"

"Donor agrees that the donation of the perpetual conservation restriction described in this deed gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. For purposes of this paragraph, the proportionate value of the donee organization's property rights shall remain constant. On a subsequent sale, exchange, or involuntary conversion of the subject property, the donee organization will be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction. All of the donee organization's proceeds from a subsequent sale or exchange of the property must be used by the donee organization in a manner consistent with the conservation purposes of the original contribution." **(Code §170; Conservation Easements)**

☞IRS Offers Guidance on Substantiating Charitable Donations (Tax Tip 2019-142)

Taxpayers who donate to a charity may be able to claim a deduction on their tax return, but only if they can itemize their deductions on Schedule A. What follows is a list of worthwhile sources when seeking to claim a charitable deduction as compiled by the IRS in this "Tax Tip."

Tax Exempt Organization Search: Taxpayers must give to "qualified organizations" to deduct their donations on their tax return. This tool can be used to find out if a specific charity qualifies as a charitable organization for income tax purposes (i.e., under **Code §501(c)**).

IRS Pub. 526, Charitable Contributions: This pub explains how taxpayers claim a deduction for charitable contributions. It provides detailed information on:

- How much taxpayers can deduct

- What records must be kept to substantiate the charitable contribution

- How charitable contributions should be shown on the taxpayer's return

IRS Pub. 561, Determining the Value of Donated Property: Taxpayers generally can deduct the fair market value of property they donate. This publication helps determine the value of donated property.

Form 8283, Noncash Charitable Contributions: Taxpayers are required to file **Form 8283** to report *noncash* (i.e., property) charitable contributions if the amount of this deduction is *more than $500*. The instructions for this form walk taxpayers through how to complete it.

Schedule A, Itemized Dedications: If a taxpayer now exceeds that applicable standard deduction amount, they can deduct donations on **Schedule A**. The instructions for this form include line-by-line directions for completing it.

Note: For 2021, an additional $300 ($600 for MFJ filers) could be added to the otherwise allowable standard deduction but this special tax break is *not* available for the 2023 tax year.

FAQs - Qualified Charitable Distributions (QCDs): Taxpayers age 70½ or older (i.e., even though the RMD age is now 72) can make a "qualified charitable distribution" from their IRA of up to $100,000 directly to an eligible charity ($100,000 by each spouse in the case of a joint return). It is generally treated as *a nontaxable* distribution made by the IRA trustee to a charitable organization. Furthermore, a QCD counts toward their minimum distribution requirement for the year.

Comment: QCDs can only be made out of an IRA. As a result, taxpayers with monies in a qualified retirement plan such as a 401(k) or a 403(b) would have to first transfer the monies into their IRA and then make a "qualified charitable distribution" to an eligible charity.

Comment: More detailed information can be found at: **Tax Topic 506 - Charitable Contributions** and **Deducting Charitable Contribution at a Glance**.

☞**Properly Reporting QCDs on Form 1040**

Qualified charitable donations will *not* be specially reflected on the **Form 1099-R** that the taxpayer would receive early next year. Even though the **TCJA** changed the required minimum distribution (RMD) age from 70½ to 72, the "qualifying age" to start making QCDs remains at 70½. Taxpayers meeting this minimal age requirement are permitted to transfer up to $100,000 annually from traditional IRAs directly to charity. And, this $100,000 annual limit is per spouse in a married filing joint situation.

What they cannot do is attempt to make a QCD *directly* from a qualified retirement plan (e.g., 401(k) or 403(b) plan) to a charity. Instead, such transfers must first be made from the qualified retirement plan to the taxpayer's IRA, and then the direct transfer to the charity can take place. But, the good news is that these QCDs can nevertheless be counted as part of a taxpayer's required minimum distributions.

Since such contributed amounts are *not* taxable (thus, they will *not* be added to your AGI, which can affect the taxation of other items such as SSBs), they do *not* count as a charitable contribution on **Schedule A**.

With regard to third-party reporting on **Form 1099-R**, it will only show the amount of the distribution. The reason behind this is that IRA custodians "do *not* have any firsthand knowledge to discern whether a particular payout meets the QCD rules." So, when completing page 1 of **Form 1040** (or, **Form 1040-SR**), taxpayers need to include the *total* amount of the IRA distributions shown on the **Form 1099-R** on **Line 4a**.Then, the QCD should be subtracted from this total with the remainder, even if $0, going on **Line 4b**. In addition, the taxpayer should write "QCD" next to **Line 4b**. If filing electronically, a drop-down box in the tax prep software for **Line 4** will give the taxpayer a choice to click "QCD." **(Code §170; QCDs)**

Related Issues: A number of related issues can arise with regard to making "direct transfers" from one's IRA to a qualified charity, such as the following:

1. What if a client does a QCD in the last week of the year and the charity does *not* cash the check until next year? Will it still count as a QCD for the year that the check was received by the charity?

Answer: First, one needs to appreciate that there are two different tax-reporting scenarios for two distinct QCD options:

IRA Check Issued by the Custodian: This is the most common approach where the IRA custodian either sends a check directly from the client's IRA to the charity or gives the client checks (from their IRA) to the charities the client has named. The key is that the check must be made out to the charity, *not* the client, to qualify as a "direct transfer."

In this case, the minute the custodian issues the check from the client's IRA, it is treated as a distribution for the current tax year, regardless of when the charity cashes the check. That is, it is debited immediately and the **Form 1099-R** is issued as a current-year distribution.

IRA Checkbook Check: In this instance, the IRA custodian provides the client with an IRA checkbook where the client can write the checks to the chosen charities.

This is very different than the first option, because the IRA custodian has no control or knowledge of any IRA checks written until they are actually cashed by the charity. They do *not* have this checkbook, so how could they know? As a result, if an IRA "checkbook check" is given to a charity in the current year, but the charity does *not* cash this check until the next year, then the distribution and **Form 1099-R** will be reported the next year by the IRA custodian.

Comment: If your client is using this second option, advise them to make sure this check is cashed immediately by the charity, that is before year-end, or the QCD option will be lost for the current year. This seems to create another tax issue, namely that it goes against the normal tax rules for making and deducting regular charitable contributions (i.e., where once a check is given to the charity, it is deductible that year, even if the charity does *not* cash until next year assuming that the taxpayer is otherwise itemizing their deductions on Schedule A v. taking the standard deduction).

If this happens with a QCD, though, the QCD option for this year would be lost, as no distribution would be reported until next year, even though a regular charitable tax deduction (i.e., as an itemized deduction on Schedule A) would be available for the current year. But, if the client is *not* itemizing, which is likely due to the increased standard deduction, then *both* the tax deduction and the QCD are lost (i.e., at least for the current tax year).

2. Can the QCD be done from a company plan, like a 401(k) or 403(b)?

Answer: No. QCDs are only available from IRAs.

3. Can the client do a rollover from a 401(k) to their IRA before yearend, and then once the funds are in the IRA, do the QCD from the IRA?

Answer: Yes, but if the client is subject to RMDs from the retirement plan (which is likely, unless a client qualifies for the "still working" exception in that plan), then that RMD must first be taken from the company plan. The RMD *cannot* be rolled over to an IRA. But, once the retirement plan RMD is satisfied, then the balance of the 401(k) can be rolled over to the IRA (if it is eligible for rollover under the company plan rules). Once the funds are in the IRA, then yes, the QCD option is available.

4. If the client already took the IRA RMD for the year, can a QCD offset that RMD income?

Answer: No. The RMD amount will be taxable, but a QCD can still be done for amounts in excess of the RMD (up to an annual limit of $100,000 per person), and that QCD will be excluded from income.

5. If the client has enough deductions to itemize, even with the new higher standard deduction amounts, does it still pay to do the QCD?

Answer: Yes, the QCD is still better tax-wise, since it will lower your client's AGI. That produces a better tax result than an itemized deduction that can only lower *taxable income*. In fact, the QCD might allow more medical expenses to be deductible as an itemized deduction since the QCD lowers AGI and thus the threshold above which medical deduction can be made (let alone, lower the possible taxation of SSBs).

6. Do Donor-Advised Funds qualify for QCDs?

Answer: No. They are specifically excluded by law, and so are private family foundations.

Comment: If you Google "**Ed Slott**" and "**IRAs**," you will find a number of useful articles covering a variety of topics concerning IRAs, as well as other retirement plan information. **(Code §408; IRAs)**

☞**Donating Vehicles to Charities - What to Know**

These rules can be a bit tricky, but here's what you need to know. Generally speaking, the donor's charitable contribution deduction cannot exceed the total proceeds received by the charity when it turns around and ultimately sells the car or truck. However, there are a few instances where the donor can instead use the FMV of the vehicle when taking a charitable deduction. And, the donee organization must issue a **Form 1098-C** if it receives worth more than $500 when and if they sell the vehicle, which then must be included with the donor's tax return. The donor would also have to include **Form 8283** in such instances for non-cash charitable contributions in such instances (i.e., where the vehicle sold for > $500). **(Code §170; Charitable Contributions)**

Comment: IRS **Pub. 4303** has the complete details on all of these rules. But, remember that even though the AGI limit for cash donations has increased from 50% to 60% of AGI, the limit for non-cash contributions is still limited to just 30% of AGI.

Comment: And, if you want to find out more about the charity that you are thinking of making a donation to, check out the **"Tax-Exempt Organization Search"** (formerly "Select Check") on the IRS website. It will have copies of the current **990 Forms** as well as the charity's IRS determination letter and other pertinent information.

☞**Similar Donated Items Aggregated for Required Appraisal on Form 8283 (*Bass*, TC Memo. 2023-41 (3/27/2023))**

The taxpayer here donated clothing in good condition to both Goodwill and the Salvation Army. He did this 170 times during the tax year in question and also got a receipt from the charity for each and every donation. His attempted tax deduction for these charitable donations was over $25,000. Yet, he insisted that not one of these gifts was over the $5,000 threshold where a "qualified appraisal" would be need to support the deduction otherwise claimed on **Form 8283** and **Schedule A**. Unfortunately, as the instructions to **Form 8283** make clear, "You must file one or more **Forms 8283** if the amount of your deduction for each noncash contribution is more than $500. You must also file **Form 8283** if you have a group of similar items for which a total deduction of over $500 is claimed." Therefore, given that he failed to obtain a "qualified appraisal," his entire charitable deduction was disallowed. **(Code §170; Charitable Donations)**

☞**Final Charitable Contribution Substantiation/Reporting Regs Include Variety of New Rules (T.D. 9836)**

The IRS has issued final regs regarding substantiation and reporting requirements for cash and non-cash charitable contribution deductions that, while largely following 2008 proposed regs, contain several new rules.

Comment: Since charitable contributions are listed on almost all Schedule As for those taxpayers itemizing their deductions, a thorough review of these regs should be done, especially for newer tax staff members.

As explained in more detail below, the final regs maintain the recordkeeping requirements and definitions of "qualified appraisal" and "qualified appraiser" from the proposed regulations, but include the following changes and additions: (1) blank pledge cards obtained from a donee that are filled out by the donor are *not* considered sufficient substantiation to support a charitable contribution deduction; (2) the final regs do *not* include the requirement that in order to demonstrate "reasonable cause" for *not* obtaining an appraisal, certain information had to be submitted with the tax return; (3) if an appraisal is required for the contribution year, it also must be attached for any carryover years; and (4) all information required by the Code must be submitted with the tax return, for example, a fully-completed **Form 8283** does *not* satisfy the requirements of **Code §170(f)(8)**.

Background: Pursuant to the **American Jobs Creation Act of 2004 (Jobs Act)** and the **Pension Protection Act of 2006 (PPA)**, the following substantiation/reporting rules apply for cash and noncash charitable contributions:

- A taxpayer is *not* permitted to deduct any contribution of a cash, check, or other monetary gift unless they maintain as a record of the contribution a bank record or a written communication from the donee organization showing its name, plus the date and amount of the contribution. (**Code §170(f)(17)**) For contributions of property (other than cash), the taxpayer must also have a receipt from the donee and keep records showing the donee's name and description of the gift. (**Code §170(f)(11)**)

- No charitable deduction is allowed for any (cash or property) contribution of $250 or more unless the taxpayer substantiates it by a "contemporaneous written acknowledgment" (*not* just a cancelled check) from the donee (or its agent). (**Code §170(f)(8)(A)**)

- For noncash contributions that are:

1. More than $500 but *not* more than $5,000, the donor must attach to its return a description of the contributed property. However, this requirement does *not* apply to a C corporation. (**Code §170(f)(11)(B)**)

2. More than $5,000 but *not* more than $500,000, the donor must obtain a "qualified appraisal" and attach to its return information about the property and appraisal (i.e., appraisal summary) as required by the IRS (exception still applies for publically-traded stock). (**Code §170(f)(11)(C)**)

3. More than $500,000, the donor must attached a qualified appraisal to its return. (**Code §170(f)(11)(D)**)

The above requirements in (2) and (3) do *not* apply to certain categories of contributions, including "qualified vehicle donations." (**Code §170(f)(11)(A)(ii)(I)**) But, the IRS will disallow a deduction for property contributed if the above reporting requirements are *not* met unless the failure was due to "reasonable cause." (**Code §170(f)(11)(A)**)

- A "qualified appraisal" is one that is:

1. Treated as a "qualified appraisal" under the regs or other guidance issued by the IRS, and

2. Conducted by a "qualified appraiser" in accordance with generally accepted appraisal standards and any regs or other guidance issued by the IRS. (**Code §170(f)(11)(E)(I)**)

A "qualified appraiser" is an individual who has earned an appraisal designation from a recognized professional organization or has otherwise met minimum education and experience requirements under IRS regs; regularly performs appraisals for compensation; and meets any other such requirements prescribed by the IRS. (**Code §170(f)(11)(E)(ii)**) However, an individual will *not* be considered a "qualified appraiser" for any specific appraisal unless they "demonstrate verifiable education and experience" in valuing the type of property subject to the appraisal, and has *not* been prohibited from practicing before the IRS at any time during the 3-year period ending on date of the appraisal. (**Code §170(f)(11)(E)(iii)**)

The IRS issued proposed regs regarding charitable contribution substantiation and reporting in 2008. Included in the proposed regs was a rule that provided that the following organizations would be treated, for purposes of determining who is a donee that can provide a written communication as proof of a charitable donation, as donees even if the organization distributes the amount contributed to one or more organizations described in **Code §170(c)**:

1. An organization described in **Code §170(c)**; or

2. An organization described in **5 C.F.R. 950.105** (i.e., a Principal Combined Fund Organization for purposes of the Combined Federal Campaign) and acting in that capacity. (**Prop. Reg. §1.170A-15(d)(1)(i)**)

Comment: United Way would be an example of an organization described at (2) in the proposed reg.

Final Regs: The new final regs generally follow the proposed regs but include the following changes and additions:

- **Contributions to Combined Federal Campaign:** The final regs adopt the general rule of the proposed regs that treats as a donee for purposes of **Code §170(f)(8)** and **Code §170(f)(17)** an organization described in **Code §170(c)** or a Principal Combined Fund Organization for purposes of the Combined Federal Campaign and acting in that capacity. (**Reg. §1.170A-15(d)(2)**) And, **Reg. §1.170A-15(d)(2)(ii)** provides that the name of the local CFC may be used instead of the name of the PCFO and may likewise be treated as the donee organization for purposes of **Code §170(f)(8)** and **Code §170(f)(17)**.

- **Blank pledge card:** The IRS noted that it is a "common practice" for a donee organization to provide a blank pledge card that is then filled out by the donor. But, in the preamble to these regs, it stated that because a blank pledge card provided by the donee organization to a donor does *not* show the necessary information required under **Code §170(f)(17)**, it is *not* considered to be sufficient substantiation for a cash, check, or other monetary gift.

- **Non-cash contribution reasonable cause exception: Prop. Reg. §1.170A-16(f)(6)** provided a "reasonable cause" exception to the various substantiation/reporting rules for non-cash contributions. It provided that, in order to show reasonable cause, certain specific information have to be submitted with the tax return. In ***Crimi*, TC Memo 2013-51 (2/14/2013)**, a case in which the Tax Court held that the taxpayer's failure to obtain a qualified appraisal was due to reasonable cause, the Court said that a reasonable cause inquiry requires that facts and circumstances must be judged on a case-by-case basis. In light of that Tax Court holding, the final regs do *not* contain a standard for the "reasonable cause" exception.

- **Form 8283**: Depending on the value of the non-cash contribution, various parts of **Form 8283, Non-cash Charitable Contributions**, must be completed and the form submitted with the tax return. The Preamble to the final regs provides that only **Section B, part IV** of **Form 8283**, which is completed for property valued at over $5,000, is considered to be a "donee acknowledgment." But, this acknowledgment "only contains some of the information required by **Code §170(f)(8)(B)**." As a result, even a fully-completed **Form 8283** does *not* satisfy the requirements of **Code §170(f)(8)**.

- Appraisals and appraisers: The following rules apply to appraisers and appraisals:

1. Attaching appraisal to carryover year returns: If an appraisal is required to be attached to the return for the contribution year, it must also be attached to the returns for the carryover years. (**Reg. §1.170A-16(f)(3)**)

2. Satisfying verifiable education requirement: Code §170(f)(11)(E)(iii)(I) requires that an appraiser have "verifiable education and experience" in valuing the type of property subject to the appraisal. **Prop. Reg. §1.170A-17(b)(2)(i)(A)** provides that an individual is treated as "having education and experience in valuing the type of property" if, as of the date the individual signs the appraisal, the individual has successfully completed (for example, received a passing grade on a final examination) professional or college-level course work in valuing the type of property, and has *two or more years* of experience in valuing the type of property.

The Preamble to the regs provides that the reference to a "passing grade on a final examination" in **Reg. §1.170A-17(b)(2)(i)(A)** is merely an example of what is considered "successful completion of professional or college-level course work," and other evidence of successful completion may be sufficient. However, "mere attendance at a training event" is *not* sufficient, and "evidence of successful completion of course work" is necessary.

3. Course work providers: The proposed regs provided that course work had to be obtained from professional or college-level educational institutions, appraisal organizations, or employer educational programs. The final regs add an additional category. Namely, recognized professional trade organizations. (**Reg. §1.170A-17(b)(2)(ii)**)

4. Appraisal designation from a recognized professional organization: One of the ways to meet the **Code §170(f)(11)(E)(ii)** requirements of is to earn an appraisal designation from a recognized professional organization. The proposed regs listed specific organizations as examples of recognized appraiser organizations. Noting that it does *not* require or prefer the designation of any particular appraisal organization, the IRS has removed the examples of specific organizations from the final regs. (**Reg. §1.170A-17(b)(2)(iii)**)

- Limited application of regs: In the Preamble, the IRS notes that the final regs apply only to *income* tax deductions for charitable contributions under **Code §170** and do *not* apply, for example, to charitable contributions for *estate or gift tax purposes*.

- IRS valuation tables not acceptable: The IRS provides various valuation tables in regs, etc. (e.g., those for charitable remainder trusts). In the Preamble, the IRS says that these tables are *not* acceptable substitutes for qualified appraisals to substantiate deductions for charitable contributions under **Code §170**.

Effective Dates: The substantive rules contained in the final regs are in **Reg. §1.170A-15, Reg. §1.170A-16, Reg. §1.170A-17** and **Reg. §1.170A-18**. **Reg. §1.170A-15, Reg. §1.170A-16,** and **Reg. §1.170A-18** apply to contributions made *after* July 30, 2018. **Reg. §1.170A-17** applies to contributions made *on or after* Jan. 1, 2019. **(Code §170; Charitable Contributions)**

☞**Charitable Deduction Disallowed Due to Inadequate Substantiation (*Izen*, (5th Cir., 6/29/2022))**

Although the mistakes seemed somewhat minor, failing to strictly comply with substantiation rules resulted in a charitable write-off being completely denied. The taxpayer claimed a $338,080 charitable deduction on **Schedule A** for donating an airplane to a local aeronautical heritage society. He did attach to his return **Form 8283** along with a written letter from the donee that described the donation. But neither the **Form 8283** nor the letter listed his Social Security number or his name. According to an 5th Circuit Court of Appeals, "substantial compliance" with the tax law requirements is *not* enough to support the charitable deduction in this case. **(Code §170; Form 8283)**

- Donations < $250: According to the IRS, non-cash contributions less than $250 must be substantiated with a receipt from the charity showing the charity's name and address, date of the contribution and a description detailed enough that even someone who is not familiar with the property type will recognize it as the property being contributed. The level of detail required depends on the value of the gift and other circumstances. For example, if you donate securities to a charity, the receipt must include the name of the issuer, the type and amount of securities and whether they are publicly traded.

- Donations >$250 and $5,000: Non-cash contributions of at least $250 and up to $500 require a "contemporaneous written acknowledgment" (CWA). And for donations between $500 and $5,000, you must obtain a CWA and file **Section A** of **Form 8283, "Non-cash Charitable Contributions,"** with your return. The tax form provides a description of the property and certain other details, including the property's fair market value and the method of determining value.

- Donations > $5,000: For non-cash contributions more than $5,000, you must obtain a CWA, file **Section B** of **Form 8283** and obtain a "qualified appraisal" of the property (although no appraisal is required for certain property, including publicly-traded securities). **Form 8283** must be signed by you, your appraiser and a representative of the charity. For donations over $500,000, you must also attach a copy of the appraisal to your return.

Code §172 - Net Operating Losses:

☞**Capital Losses Cannot Be Carried Back as Part of NOL Calculation (*Swartz*, 17-cv-5914 (ERK) (AKT) (D.C., N.Y., 7/20/2021))**

Capital losses can offset capital gains plus up to $3,000 of other income with any excess losses being carried forward indefinitely until exhausted. Here, an investor who tried to carry back his capital losses from a worthless investment as net operating losses and claim a refund on his previously filed tax returns. The District Court agreed with the IRS that individuals may only carry back excess ordinary losses incurred in a trade or business (including nonpassive rental losses), but *not* losses from a capital asset investment. The taxpayer argued that his losses "were derived from a trade or business," but the court confirmed that he "was merely holding this investment as a capital asset." **(Code §165; Capital Losses)**

☞**Use of NOL Carryback Enabled IRS to Open Closed Tax Year and Deny Previously Allowed Deduction (CCM 20114701F)**

A taxpayer carried back a net operating loss to a year in which the Service had previously approved a write-off of worthless stock. And, even though that year was now closed, the IRS decided in this Chief Counsel Memo that the NOL carryback allowed it to re-examine the year and deny the worthless stock deduction, limited to the amount of the loss carryback. **(Code §172; NOLs)**

> **Comment:** The bottom line is that the use of the NOL carryback (i.e., submitting an amended return for a refund) gave the Service "a second bite at the apple."

<u>Code §183 - Hobby Losses</u>:

☞**Determining If Pastime Is Hobby v. Legitimate Business (Tax Tip 2022-106)**

From collecting stamps and woodworking to crafting and quilting, people have all kinds of hobbies. As such, most of these hobbies will never result in a profit on a year-to-year basis. For hobbies that do earn income (i.e., otherwise have gross receipts), individuals should realize that they are required to report it on their tax return. They should also be mindful that their hobby might be a business.

> **<u>Comment</u>:** If the endeavor is only a "hobby," then the gross receipts are reported as "Other Income" on **Schedule 1, Line 8i** of **Form 1040**. Moreover, none of the expenses related to this "hobby" may be deducted since the **TCJA** eliminated "2% miscellaneous deductions" from **Schedule A**. If, instead, the endeavor rises to the level of actually being a "business," then **Schedule C** is used to report the gross receipts along with any expenses.

- Classification of business v. hobby: Determining whether an endeavor should classify the activity as a hobby or a business can be a source of confusion. But, the bottom line is that a business should be operated to make a profit. On the other hand, individuals pursue hobbies for sport or recreation, *not* profit. There are a few other things people should consider when determining if their project is a hobby or business. No single consideration is the deciding factor, but taxpayers should review all of them when determining whether their activities are a business.

Here are some of the things taxpayers should evaluate to decide whether they have a hobby or a business:

• Whether the taxpayer carries out the activity in a businesslike manner and maintains complete and accurate books and records.

• Whether the time and effort the taxpayer puts into the activity show they intend to make it profitable.

• Whether they depend on income from the activity for their livelihood.

• Whether any losses are due to circumstances beyond the taxpayer's control or are normal for the startup phase of their type of business.

• Whether they change methods of operation to improve profitability.

• Whether the taxpayer and their advisors have the knowledge needed to carry out the activity as a successful business.

• Whether the taxpayer was successful in making a profit in similar activities in the past.

• Whether the activity makes a profit in some years and how much profit it makes.

• Whether the taxpayers can expect to make a future profit from the appreciation of the assets used in the activity. **(Misc.; Hobby Losses)**

> **<u>Comment</u>:** More detailed information can be found in the following publications:
>
> **IRS Pub. 17, Your Federal Income Tax**

IRS Pub. 525, Taxable and Nontaxable Income

IRS Pub. 535, Business Expenses

IRS Pub. 334, Tax Guide for Small Business, For Individuals Who Use

IRS Pub. 334, Tax Guide for Small Business

☞IRS Releases ATG on Hobby Loss Rules

The IRS released a revised **Audit Techniques Guide (ATG) on Activities Not Engaged in for Profit IRC Sec. 183**. ATGs are intended "to help IRS examiners during audits by providing insight into issues and accounting methods unique to specific industries." While ATGs are designed to provide guidance for IRS employees, they're also useful to small business owners and tax professionals who prepare tax returns. ATGs explain industry-specific examination techniques and include common, as well as, unique industry issues, business practices, and terminology. Guidance is also provided on the examination of income, interview techniques, and evaluation of evidence so they may be helpful for business and tax planning purposes. **(Code §183; Hobby Losses)**

> **Comment:** IRS auditors will focus on whether the activity generating the losses on **Schedule C** or **Schedule F** is engaged in with the intent to make a profit. There are nine specific factors used by the IRS to make this determination. In addition, IRS auditors will tour the business and conduct interviews with the taxpayer or their representative.

☞GIG Economy and Other Side Businesses - Treated as Hobby for Tax Purposes?

Now that the TCJA has elimination 2% miscellaneous itemized deductions (or, the taxpayer is choosing instead to take the applicable standard deduction v. itemizing their deductions), this becomes an important question since you would have to pick up all of the gross receipts but would simultaneously be denied any deductions as an offset.

> **Comment:** Even with a marijuana dispensary business which is legal under state or local law, but illegal under federal law, you are at least allowed to offset the cost of the marijuana sold, even though all other expenses associated with the business are disallowed when calculating federal (v. state) taxable income.

The IRS has recently put out some guidance (**Tax Tip 2020-108**) reminding taxpayers that whether it is something that they have been doing for years or something they just started to make extra money, income earned from "hobbies" have to be included in gross income. But the key question continues to be what is the difference between a "hobby" and a "business?" The Service stresses that a "business" operates to make a profit, while people engage in a "hobby" for sport or recreation, *not* to make a profit.

According to the Service, here are **nine criteria** that taxpayers should consider when determining if an activity is a hobby or a business:

1. Whether the activity is carried out in a businesslike manner and the taxpayer maintains complete and accurate books and records;

2. Whether the time and effort the taxpayer puts into the activity show they intend to make it profitable;

3. Whether they depend on income from the activity for their livelihood;

4. Whether any losses are due to circumstances beyond the taxpayer's control or are normal for the start-up phase of their type of business;

5. Whether they change methods of operation to improve profitability;

6. Whether the taxpayer and their advisors have the knowledge needed to carry out the activity as a successful business;

7. Whether the taxpayer was successful in making a profit in similar activities in the past;

8. Whether the activity makes a profit in some years and how much profit it makes; and

9. Whether the taxpayers can expect to make a future profit from the appreciation of the assets used in the activity.

> **Comment:** As to this last standard, it can used to "forgive" the fact that a number of the other criteria were not met. For instance, if the land involved in a horse breeding activity which had numerous years of losses was then sold for a multi-million profit, that might prove that the activity was carried on with the intent to make a profit, and was *not* "just a hobby."

Each set of circumstances has to be considered separately, but showing a profit for at least three out of the first five years shifts the burden of proof for demonstrating that the "business" is actually a "hobby" from the taxpayer to the IRS. So, whether it is a more unstructured situation such raising horses or other animals, or an Amway, Uber or Lyft business, the above-mentioned criteria come into play. Even if you can overcome the presumption of the activity being a "hobby," and therefore a loss might initially be considered for tax purposes, the **Code §469** passive loss rules can still result in the denial of a current loss be claimed due to the taxpayer's "material participation" (i.e., with the loss being formally suspended on **Form 8582**). **(Code §183; Hobby Losses)**

☞**Rent Paid to Themselves Only Exacerbated Taxpayer's Nondeductible Hobby Losses (*Estate of Stuller*, No. 15-1545 (7th Cir., 1/26/2016))**

A couple owned a horse breeding venture through an S corporation that was found to be a "hobby loss" situation. As a result, they were *not* allowed to deduct the net losses that flowed through to them on the K-1. The taxpayers lived in IL where they owned and operated a number of fast-food franchises. Meanwhile, the horse breeding activity was located on farmland that they owned in TN. The couple's S corporation hired a trainer to manage the farm, paid him for his services and agreed to split any prize money and other revenues with him. Nevertheless, the activity incurred significant losses over a 15-year period. In addition, the IRS found the company's records "to be a mess," and the business never made "the changes necessary to rectify its finances." The bottom line was that it "was *not* run in a businesslike manner, and the firm lacked the requisite profit motive." But, that did *not* prevent the rents that the S corporation paid to the couple for use of the TN property from being includible in their gross income. And, when the court denied their flowthrough losses from this hobby, the couple sought a credit for the previously-taxed rent amounts since they did *not* get an income tax benefit from the rent deductions on the S corp's return. But, the court upheld the Service's decision that this should be disallowed as well. **(Code §183; Hobby Losses)**

> **Comment:** Basically, this is a "timing" issue. The couple has to pick up the rental income even though they cannot deduct the increase in the hobby losses that were a result of these rent deductions. And, even when the farmland on which the hobby activity was located is sold, this Sec. 1231 gain will be on **Form 4797** of the couple's personal return (i.e., it is *not* a gain allocable

to the S corp against which the suspended hobby losses could be taken). As a result, they would be well-advised, at least from a tax standpoint, to do a **Code §351** transfer of this farmland to the S corp *before* it was sold so that the entity would now, hopefully, have some income which could be offset with the suspended hobby losses. Note that the hobby losses can be offset by profits of the activity, or by the gain generated by the sale of land on which the activity was located. **But, after 2017, these suspended losses (as well as any current expenses of this hobby) are still "separated" from any such income or gain as 2% miscellaneous itemized deductions as discussed below which are now nondeductible, so there is no carryover of these losses to be used in future tax years.**

Comment: Hopefully, the horse breeding activity will eventually become profitable. But, even then, (and, unlike normal business reporting on either Schedule C or F) any gross receipts have to be picked up as "Other Income" on **page one** of **Form 1040** (or, in this case, as K-1 income on page two of Schedule E), while the related expenses are a 2% miscellaneous itemized deduction on Schedule A (subject to the phaseout and possible AMT addback). **Otherwise, these hobby losses will permanently go to waste for tax years after 2017.**

Code §213 - Medical & Dental Expenses:

☞Medicare Premiums and S/E Health Insurance Deduction

Self-employed individuals are allowed to deduct their Medicare premiums as a subtraction in arriving at AGI (i.e., above-the-line-deduction). Medicare premiums paid by a self-employed individual are included in this deduction for health insurance on **Schedule 1** of **Form 1040**. This also applies for partners, provided the partnership reimburses the partner for the premiums and the amounts are reported as guaranteed payments (i.e., **Box 4** of **Schedule K-1**) that are taxed as self-employment income (i.e., **Box 14** of **Schedule K-1**). Similar rules apply to S corporation shareholders who own *more than 2%* of the firm when the shareholder pays the premiums and then gets reimbursed by the S corporation. Under **Rev. Rul. 91-26**, the premiums must be included as wages on the shareholder's W-2 form (but are *not* subject to employment taxes in **Boxes 3** and **5** of the W-2).

The question often comes up as to whether a spouse's Medicare premiums treated in the same fashion? Initially, the answer appeared to be yes, but the IRS has clarified that this is *not* the case. As a result, premiums paid by a spouse of a self-employed person likely cannot be claimed on **Schedule 1** unless the spouse is also a self-employed individual. **IRS Pub. 535** says that Medicare premiums are required to be paid in the name of the self-employed person or the business to qualify for the **Schedule 1** deduction. However, this non-self-employed spouse's Medicare premiums can be included in medical expenses and deducted on **Schedule A** to the extent total medicals exceed 7.5% of AGI, and if the couple itemizes. **(Code §213; Medicare Premiums)**

☞Proposed Regs Offer Guidance on Deductibility of Medical Care Arrangement Payments (REG-109755-19)

The IRS has released proposed regs which would treat taxpayer-paid expenses related to certain medical care arrangements, including direct primary care arrangements, health care sharing ministries, and certain government-sponsored health care programs, as deductible under **Code §213**. Also, a health reimbursement arrangement would be able to provide tax-free reimbursements to employees for direct primary care arrangement fees and for payments for membership in a health care sharing ministry.

Background: Code §213(a) allows a deduction for expenses paid during the tax year, *not* compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse, and the taxpayer's dependent, to the extent the expenses exceed 7.5% of adjusted gross income (AGI). **Code §213(d)(1)** defines "medical care" as amounts paid for:

A. The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body;

B. Transportation primarily for and essential to obtaining medical care referred to in (A);

C. Qualified long-term care services; or

D. Insurance covering medical care and transportation as described in (A) and (B), respectively (i.e., "medical insurance"), including supplementary medical insurance for the aged (e.g., Medicare Part B), and any qualified long-term care insurance contract.

An HRA is, in general, a type of “account-based group health plan” funded solely by employer contributions (i.e., with no salary reduction contributions or other contributions by employees) that reimburses an employee solely for medical care expenses incurred by the employee (and, at the discretion of the plan sponsor, the employee's family), up to a maximum dollar amount for a coverage period. (**Notice 2002-45**)

On June 24, 2019, the president issued **Executive Order 13877**, **"Improving Price and Quality Transparency in American Healthcare to Put Patients First."** The Executive Order directs the IRS to "propose regulations to treat expenses related to certain types of arrangements, potentially including direct primary care arrangements and healthcare sharing ministries, as eligible medical expenses under **Code §213(d)**."

Proposed Regs: According to the preamble, the proposed regs have been developed in response to the above-mentioned Executive Order. Expenses paid for medical care would include amounts paid for a “direct primary care arrangement” (as defined below). And amounts paid for membership in a “health care sharing ministry” (as defined below) that shares expenses for medical care, would be treated as payments for “medical insurance” under **Code §213(d)(1)(D)**.

A "direct primary care arrangement" includes a contract between an individual and one or more primary care physicians under which the physician or physicians agree to provide medical care for a fixed annual or periodic fee without billing a third party. (**Prop. Reg. §1.213-1(e)(1)(v)(A)**)

Meanwhile, for the purpose of **Code §213**, a “health care sharing ministry” would be an organization:

1. Which is described in **Code §501(c)(3)** and is exempt from taxation under **Code §501(a)**;

2. Members of which share a common set of ethical or religious beliefs and share medical expenses among members in accordance with those beliefs and without regard to the State in which a member resides or is employed;

3. Members of which retain membership even after they develop a medical condition;

4. Which (or, a predecessor of which) has been in existence at all times since December 31, 1999, and medical expenses of its members have been shared continuously and without interruption since at least December 31, 1999; and

5. Which conducts an annual audit which is performed by an independent certified public accounting firm in accordance with generally accepted accounting principles and which is made available to the public upon request. (**Prop. Reg. §1.213-1(e)(4)(i)(A)(2)**)

The definition of health care sharing ministry is the *same* as is found in **Code §5000A(d)(2)(B)(ii)** (i.e., regarding the "minimum essential coverage" rules for purposes of the **Affordable Care Act's** "individual mandate"). Under the proposed regs, an HRA would be able to provide reimbursements for direct primary care arrangement fees, as well as for membership in a health care sharing ministry as a "medical care expense" under **Code §213(d)**.

The proposed regs would also treat the following government-sponsored health care programs as "medical insurance coverage" under **Code §213(d)(1)(D)**:

i. The Medicare program under title XVIII of the Social Security Act, including Parts A, B, C, and D;

ii. Medicaid programs under title XIX of the Social Security Act (42 USC 1396 et seq.);

iii. The Children's Health Insurance Program (CHIP) under title XXI of the Social Security Act (42 USC 1397aa et seq.);

iv. Medical coverage under chapter 55 of title 10 USC, including coverage under the TRICARE program (i.e., insurance for members of the military and their families); and

v. Veterans' health care programs under chapter 17 or 18 of title 38 USC. (**Prop. Reg. §1.213-1(e)(4)(i)(A)(3)**)

Comment: These government-sponsored health care programs have historically been treated as deductible medical care costs by the IRS.

As a result, to the extent one of these government-sponsored health programs requires individuals to pay premiums or enrollment fees for coverage under the program, those amounts would be eligible for a deduction as a "medical expense" under **Code §213**.

Effective Date: The proposed regs are scheduled to apply for tax years that begin *on or after* the date of publication of a Treasury decision adopting these rules as *final* regulations in the Federal Register. **(Code §213; HRAs)**

Code §223 - Health Savings Accounts:

☞Health Savings Account Amounts for 2023 (Rev. Proc. 2022-24)

HSAs allow eligible individuals to make deductible contributions that can be withdrawn tax-free for reimbursement of eligible medical expenses (i.e., as defined in **Code §213**). For 2023, the limitation on HSA deductions is $3,850 (up from $3,650 for 2022) for an *individual* with self-only coverage under a high deductible health plan (HDHP) or $7,750 (up from $7,300 for 2022) for *family* coverage. An HDHP is defined under **Code §223(c)** as a health plan with an annual deductible *not* less than $1,500 (up from $1,400 for 2022) for *self-only* coverage or $3,000 (up from $2,800 for 2022) for *family* coverage, with annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but *not* premiums) *not* exceeding $7,500 (up from $7,050 for 2022) for *self-only* coverage or $15,000 (up from $14,100 for 2022) for *family* coverage. **(Code §223; HSAs)**

☞**2024 Inflation-Adjusted HSA Amounts (Rev. Proc. 2023-23)**

HSAs allow eligible individuals to make deductible contributions that can be withdrawn tax-free for reimbursement of eligible medical expenses. For 2024, the limitation on HSA deductions is $4,150 (up from $3,850 for 2023) for an individual with self-only coverage under a high deductible health plan (HDHP) or $8,300 (up from $7,750 for 2023) for family coverage. An HDHP is defined under **Code §223(c)** as a health plan with an annual deductible *not* less than $1,600 (up from $1,500 for 2023) for self-only coverage or $3,200 (up from $3,000 for 2023) for family coverage, with annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but *not* premiums) *not* exceeding $8,050 (up from $7,500 for 2023) for self-only coverage or $16,100 (up from $15,000 for 2023) for family coverage. **(Code §223; HSAs)**

> **Comment:** Essentially, HSAs can also be looked at as "disguised IRAs" since once an individual goes on Social Security the HSA funds, though taxable, can be used for any purpose without penalty. Also, remember that the initial funding of an HSA can be done with IRA monies which is something to consider for younger taxpayers who typically have large deductibles on their health insurance policies, yet little cash reserves to handle unexpected out-of-pocket medical costs. The bottom line is that HSAs should maybe be prioritized over Roth IRAs for these individuals.

☞**IRS Modifies Guidance on COVID-19 Expenses for HDHPs, Provides Preventive Care Clarifications (Notice 2023-37)**

In response to the end of the COVID-19 emergency, the IRS has issued this notice which modifies its 2020 guidance regarding the COVID-19 testing and treatment benefits that can be provided by a high-deductible health plan (HDHP). Originally, under the 2020 guidance, HDHPs were allowed to provide those benefits "without a deductible or with a deductible below the applicable HDHP minimum deductible (self-only or family)." As a result, individuals were permitted to receive coverage under HDHPs that provided such benefits on a no- or low-deductible basis without any adverse effect on HSA eligibility (i.e., as far as being able to make contributions to HSAs). This latest notice provides that, due to the end of the COVID-19 emergency, the relief described in the 2020 guidance is no longer needed and will apply only for plan years ending *on or before* December 31, 2024. **(Code §223; HSAs)**

> **Comment:** The bottom line is that if expenses such as screening for COVID-19 (or, other common conditions such as flu) are incurred *after* 2024 and the cost is fully covered (i.e., with no deductible or co-pay), then continuing contributions would *not* be allowed since you would no longer be dealing a "high deductible health plan." To be clear, however, such screening costs would still be a "qualified medical expense" under **Code §213** which could at least be reimbursed by HSA funds.

> **Example:** Assume now that the HSA owner has now reached age 65 and qualifies for Medicare as of August 1st of the current tax year. Since eligibility testing for HSA contributions is made of the first day of each month, no more contributions to this HSA can be made as of this date going forward. Nevertheless, any qualified medical expense incurred since the first day of the tax year when this HSA was originally set up can be reimbursed (i.e., regardless of the fact that the HSA owner no longer is covered by a HDHP and cannot make future contributions to the account).

> **Comment:** Keep in mind, however, expenses for "preventive care" can be covered dollar-for-dollar by HDHP, even if the deductible has *not* been met. Alternatively, preventive medical costs can be covered by a lower deductible, depending on the terms of the health insurance policy.

<u>Code §280E - Expenditures in Connection with Illegal Sale of Drugs</u>:

☞**Deductions Denied Except for Costs of Goods Sold Claimed by Medical-Marijuana Dispensary (*Patients Mutual Assistance Collective Corp., et al.*, 151 TC No. 11 (11/29/2018))**

The Tax Court *affirmed* the Service's denial of a California medical-marijuana dispensary's deductions for ordinary and necessary business expenses. Only allowed were for the costs of goods sold, plus the transportation costs of acquiring this inventory.

> **Note: Nothing in any of the recent tax proposals would affect this nondeductibility of costs, at least at the federal income tax level.**

<u>Background</u>: Under **Code §162(a)**, a business is permitted to deduct from its gross income all of the "ordinary and necessary expenses" paid or incurred during the tax year in carrying on the trade or business. However, under **<u>Code §280E</u>**, no "deduction or credit shall be allowed for any amount paid or incurred during the tax year in carrying on any trade or business if such trade or business (or, the activities which comprise such trade or business) consists of trafficking in controlled substances" as defined under Federal law, despite the fact that several state legislatures have passed laws legalizing the cultivation and sale of marijuana. **(<u>Code §280E</u>; Medical Marijuana)**

> **<u>Comment</u>:** At least you get a COGS deduction here, as opposed to a "hobby business" where you have to pick up all gross receipts derived therefrom, while getting nothing as far any deductions (since they would be 2% miscellaneous deductions otherwise eliminated after 2017 by the TCJA).

<u>Code §469 - Passive Loss Rules</u>:

☞**Short-term Rentals Treated as "Trades or Businesses" for PAL Rules (*Lucero*, TC Memo. 2020-136 (9/29/2020))**

Normally, rental activities are treated as *automatically* passive under **Code §469**. One of the exceptions is where a taxpayer qualifies as a "real estate professional" who materially participates in their rental activities. But, another sometimes overlooked exception involves rentals where the "average stay" by tenants is 7 days or less (i.e., typical of resort type locations). The good news is that the landlord has a chance to prove that they "materially participated" in the rental activity (i.e., under any of the seven distinct "material participation" standards). On the other hand, though, is the fact that hours spent on these "short-term rentals" does *not* count toward achieving "real estate professional status." In this instance, a couple owned beachfront property that they rented out over the years for an average rental period of seven days or less, while employing a management company to get tenants, collect rents, clean and arrange for additional maintenance and repairs. The taxpayers visited the property occasionally to buy supplies and to also make some repairs. Nevertheless, they failed to convince the Tax Court that they materially participate in this rental activity and therefore had to suspend any net rental losses (i.e., on **Form 8582** until such time as they had sufficient passive income to offset these losses, or the "disposition rule" came into play). The Court was *not* convinced that the couple devoted at least 100 hours each year to the activity and that their participation was more than anyone else involved with the property (especially where they had a property management firm handling day-to-day responsibilities). And it did *not* help matters that the taxpayers failed to keep any contemporaneous logs, calendars, or other documentation stating the number of hours they spent on this rental activity. **(<u>Code §469</u>; Short-term Rentals)**

> **<u>Comment</u>:** The same conclusion was reached in a case with a similar set of facts where a couple owned rental properties at resort locations in Colorado, Mexico and Hawaii and used a property

management company to handles these short-term rentals. (***Eger*, No.19-17022 (9th Cir., 8/13/2020)**) The IRS continues to aggressively pursue these cases, especially where the taxpayers maintain no contemporaneous (or, any) records supporting their time involvement and these rental properties are located at resorts far from the taxpayer's home.

☞**Material Participation Test Met Despite Significant Time Away from Business Location (*Barbara*, TC Memo 2019-50 (5/13/2019))**

A taxpayer whose business was located in Chicago, but who lived 60% of the year in Florida and worked from that home while he was in Florida, was *not* engaged in a passive activity because he materially participated in the business activity "on a regular, continuous, and substantial basis."

Background: **Code §162(a)** and **Code §212(1)** allow taxpayers to deduct certain business and investment expenses, but **Code §469** limits those deductions when they arise from "passive activities." A passive activity is any activity involving the conduct of a trade or business in which the taxpayer does *not* "materially participate." A taxpayer is considered to have "materially participated" in an activity if such participation is "regular, continuous, and substantial." Regs provide *seven* distinct alternative tests to determine whether a taxpayer has "materially participated" in an activity for the tax year. (**Reg. §1.469-5T(a)**) The *seventh* test is met if:

1. The taxpayer participates more than 100 hours in the activity during the year, and

2. The facts and circumstances show that the participation was regular, continuous, and substantial. (**Reg. §1.469-5T(a)(7), Reg. §1.469-5T(b)(2)(iii)**)

Facts: The taxpayer was in the business of lending money. The office of the lending business was in Chicago. The office was staffed by two full-time employees (an accountant and a secretary). The taxpayer performed all executive functions for the lending business. For instance, he decided when to make loans and how to handle defaulted loans. He also managed over 40 outstanding loans during the four years at issue and had no other significant work-related demands on his time besides the lending business.

During the years 2009-12, the taxpayer split his time between Chicago and Florida. For each year, he was in Chicago 40% of his time and in Florida 60% of his time. He worked at least 200 days in a year, proportioned between Chicago and Florida on a 40/60 basis. When in Chicago, he was in the Chicago office for about 5¾ hours each work day working on the lending business while keeping a regular schedule. Meanwhile, when he was in Florida, the taxpayer lived in a house that he owned and called the Chicago office every day when it opened at 9 a.m. He also communicated with the office at other times, through telephone, fax, and e-mail. He averaged at least two hours of work per day on the lending business while in Florida. The business had losses for the three of the years at issue and the IRS contended that these were passive activity losses and that the taxpayer did *not* materially participate.

Tax Court Decision: The Court agreed that the taxpayer did in fact "materially participate" in his lending business. It concluded that the taxpayer met the requirements of **Reg. §1.469-5T(a)(7)** and **Reg. §1.469-5T(b)(2)(iii)** and therefore that his lending business was *not* a passive activity. A key factor was that he was in the Chicago office at least 460 hours per year working on the lending business, computed as follows: 200 days × 40% × 5.75 hours = 460 hours per year. It also determined that he worked at least 240 hours per year on the lending business while he lived in Florida, computed as follows: 200 days × 60% × 2 hours = 240 hours per year. As a result, his total hours participating in the lending business each year were 700 or more. And, the Court concluded that both while he was in Chicago and in Florida, the taxpayer's participation in the lending business was "regular, continuous and substantial.

Comment: Reg. §1.469-5T(a)(1) provides that a taxpayer "materially participates" in an activity if he participates in the activity for *more than 500 hours* during the tax year. However, the Court in this case made no mention of this specific test. But, it was a shame that this case, given the recordkeeping that occurred, could not have been settled at the audit or IRS appeals level, and that the taxpayer had to incur the cost of taking the matter to the Tax Court to be resolved. (**Code §469**; PALs)

☞**Surgeon's Interest in Surgical Center Separate from His Day-to-Day Practice for PAL Rules (*Hardy*, TC Memo 2017-16 (1/17/17))**

The taxpayer was a plastic surgeon who operated as a sole practitioner (i.e., a SMLLC) performing surgeries at various facilities in the Missoula, MT area. He also owned a minority interest in a surgical center (i.e., an LLC treated as a partnership for tax purposes) where he did operations on a sporadic basis, but otherwise had no day-to-day management responsibilities. After reporting the K-1 income from this latter trade or business as *nonpassive* income for a number of years, he was then advised by his CPA that this was, in fact, a source of *passive* income (i.e., since he was *not* materially participating under any of the 7 "tests" outlined in **Code §469**). He then used this income going forward to offset other passive losses on his personal return.

The IRS issued a notice of deficiency for the three open tax years, along with imposing an accuracy-related penalty. The Service insisted that since both of these activities were in the "medical field," they should be grouped together as one *nonpassive* activity. Essentially, the IRS was asserting that since the taxpayer had reported this K-1 income in prior years as *nonpassive*, that a grouping election (i.e., with his day-to-day SMLLC practice) should be inferred (with the result that it could *not* now be "un-grouped" without the Service's expressed permission).

Comment: As a side note, he also sought a refund for the self-employment taxes that he had paid on the profits from the LLC in which he was, in fact, just a mere investor. Also, the IRS, in the interim, has issued **TAM 201634022** which addressed the facts in this case, advising its agents in the field that the fact both activities are in the same field (here, medical) does *not* necessarily mean that they must be grouped as one activity for purposes of the passive loss rules. Instead, it depends on the underlying facts and circumstances in each individual case.

Comment: When it involves *rental* activities, the regs dictate that any grouping election must be done on an "all-or-nothing" basis. On the other had, where *trade or business* activities are involved, whether or not a grouping election can be made depends on whether such a combined activity would constitute an "appropriate economic unit." In this regard, **Reg. §1.469-4(c)** lists the following five factors as the most important items to consider: (1) Similarities and differences in the underlying types of trades or businesses; (2) The extent of common control; (3) The extent of common ownership; (4) Geographical location; and (5) Interdependencies between or among the activities. The regs do emphasize, however, that taxpayers can "use any reasonable method of applying the relevant facts and circumstances" to group activities and that *not* all of the five factors are "necessary for a taxpayer to treat more than one activity as a single activity." As a result, taxpayers have some flexibility in determining what constitutes an "appropriate economic unit." Nevertheless, **Reg. §1.469-4(e)**, provides that once a taxpayer has grouped activities, the taxpayer is *not* permitted to regroup those activities unless "it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate" (although, in the *first* tax year that the taxpayer is exposed to the **Code §1411** 3.8% Medicare surtax on **Form 8960**, they are free to reconsider any and all grouping elections that they might have previously made without any input or permission from the IRS).

Tax Court Decision: The Court agreed with the taxpayer that the mere fact that he had treated the K-1 income in the past as *nonpassive* income should *not* be construed as if an informal election to group the two activities had, in fact, been made. Furthermore, this is *not* akin to a situation where, solely for the purpose of creating a PIG (i.e., a "passive income generator"), a group of physicians decided to transfer their medial equipment (e.g., X-ray, MRI, CAT scan, etc.) into a separate LLC, for instance, solely to convert some of their future profits from their medical practice into passive rental income (i.e., that they would now pay in the form of "self-rental income" to this controlled entity). Here, the taxpayer was finding it increasingly more difficult to obtain space at nearby hospitals to performed his surgeries. He even went so far as buying a separate parcel of land on which he would build his own surgical building. But, in the end, it was more cost effective to buy into a similar facility that already existed, but in which he had no control or involvement on a day-to-day basis. As a result, the reclassification of his K-1 income from this minority business investment (which was in no way based on how many surgeries he individually performed there) was allowed as passive income. **(Code §469; Grouping Elections)**

Comment: Under the decision in **(*Barnes*, 111 AFTR 2d ¶ 2013-611 (CA DC 04/05/2013)** that since passive income was arguably available in earlier closed tax years, any suspended passive losses on **Form 8582** *for such years were deemed absorbed and, therefore, not* now available on a carryforward basis. In fact, this is what the Tax Court stated in its decision.

☞**Does Loss of REP Status Mean Sec. 1411 Medicare Surtax Applies to Sec. 1231 Gain?**

Assume you have a client heavily involved in "real estate trades or businesses," and has been so for over 5 years, meeting both the 750-hour test, as well as the > 50% test. And, with this status of being a "real estate professional," he then "materially participates" in these real estate activities (e.g., multiple rental properties) for, again, at least 5 of the last 10 years.

Then, after **more than 5 years** of materially participating in these activities (along with being a REP), he decides to retire early in the current tax year (i.e., before he has even come close to meeting the 750-hour test) and sells off his remaining rental property investments. As a result of *not* meeting this REP test, the activity would normally revert back to being a passive activity (in fact, "automatically" passive since a rental activity is involved).

Two questions arise:

(1) Can the significant gain on the sale of the property be treated as passive income (i.e., a "PIG") should the taxpayer have a need to offset either current or suspended passive losses (i.e., on **Form 8582**)?

(2) Or, given that the taxpayer does *not* need any passive income, and is more concerned above the **Code §1411** 3.8% Medicare surtax applying to any "net investment income" (i.e., on **Form 8960**) which would include passive income resulting from this Sec. 1231 gain, could an argument be made that he had previously "materially participated" for at least "5-out-of-the-prior-10-years test" and, therefore, this income would be treated as nonpassive?

There does *not* seem to be any specific court case dealing with this issue, and the IRS has *not* issue any direct ruling which would appear to address this matter. But, looking at the general principles of the legislative regs that Michael Grace issued from 1987 through 1991 which cover **Code §469**, he made it clear that there was some concern that taxpayers would attempt to artificially create a PIG (i.e., passive income generator) by simply stopping to materially participate in a "former nonpassive activity" such as a trade or business. Or, as an alternative, they would rent real estate held in a separate entity such as an LLC to a trade or business (regardless of entity type) in which these "landlords" materially participated (i.e., a "self-rental" situation).

Example: A mother and father ran a highly-successful business (e.g., LLC/partnership or S corp) and after many years, decided to retire by passing on the business to their son and daughter, selling it to them on an installment basis. However, having significant passive losses from other investments suspended on their **Form 8582**, they attempted to treated the future K-1 income still flowing through from this company, as well as gain from the installment note being paid off by their children to them, as a source of passive income which would be sheltered by the freed-up suspended passive losses.

Test #5 under the seven distinct "material participation rules/regs" states that if the taxpayer materially participated in an activity for at least 5 out of the prior 10 years (whether consecutive or not), then the future treatment of this activity would continue to be nonpassive regardless of whether or not their material participation continued. Therefore, in this "trade or business" example, any future K-1 income, as well as any gain realized from the sale of their ownership interest, would be deemed nonpassive (at least for the first 5 years of the parents' retirement when this "5-out-of-the-prior-10-test" would still be met).

Comment: The "good news" in the example above is that any K-1 income or gain on sale would *not* be subject to the **Code §1411** 3.8% Medicare surtax (i.e., as shown on **Form 8960**) since it continue to be treated as nonpassive income. But, the "bad news" would be that they would have to find other sources of passive income (or, use the "disposition rule") to free up their other suspended passive losses on **Form 8582**.

Note: Congress has proposed that we include nonpassive income in the definition of "net investment income" for purposes of the Code §1411 3.8% Medicare surtax if such income is *not* otherwise subject to employment taxes (e.g., rents received by REP or nonpassive self-rental income, as well as S corp distributions to "active" owners).

The question remains that the taxpayer involved in this inquiry, and while he was a "real estate professional," he was clearly involved in a "nonpassive activity" (i.e., even though rental activities are normally, and automatically, treated as passive under the tax law). And, he had done so for at least 5 prior years. So, when the REP tests (specifically, the "750-hour test") were *not* met in the year of sale, do we simply ignored **"Test #5"** of the "material participation" standards? What if this REP wanted to have passive income on the sale of one of his rental properties (let alone, any net rental income for the year)? So, he deliberately fails one of the REP tests (such as the 750-hour test)? Or, would it make any difference if, instead, he continued to meet the REP tests, but deliberately failed to "materially participate" in the real estate trade or business (i.e., rental activity)? Would the IRS (or, Tax Court) ignore the fact that this was an activity that he had in fact materially participated in for at least 5 out of the previous 10 years?

Conclusion: If one were to do a strict "black letter law" reading of the Code, it would appear that the general principal that rental activities are to be treated a "per se" passive, regardless of involvement in the underlying activity, unless both of the requirements under the "real estate professional" test were met. And, in meeting these two REP "tests" (i.e., ">750 hours" and ">50% involvement in real estate trades or businesses"), there is no "material participation look-back rule" (i.e., such as with Tests #5 and #6 for material participation in a former passive activity such as a trade or business). As a result, the rental activity would revert to being "per se" (i.e., automatically) passive in the year that the large gain generated by the sale of the underlying real estate occurred. The "good news" would be that this gain is passive (along with any net rental income in the year of sale), should the taxpayer need a source of passive income to offset other current (or, suspended) passive losses. But, the "bad news" is that **Form 8960** would have to be completed with the gain being included in overall "net investment income" otherwise subject to the 3.8% Medicare surtax.

The bottom line with this particular client, was that they were *not* looking for a source of passive income, but rather avoiding the Medicare surtax on this large Sec. 1231 gain. **And, there is no question that the taxpayer was no longer a "real estate professional" (i.e., given that he no longer meets the "750-hour test").** Furthermore, relying on **"Test #5"** of the material participation tests only applies to non-rental activity such as T/Bs where the "real estate professional" does *not* come into play. **And, if he is no longer a REP, you do not even get to consider whether he "materially participated" in the year that he sells his rental properties and realizes significant Sec. 1231 gains. (Code §469; Real Estate Professional)**

> **Comment:** Looking at that last sentence above, suppose the taxpayer clearly continued to meet the REP tests. But, needing a source of passive income, he simply stopped "materially participating" in the rental activity? **In that case, it would appear that, as with any other former passive activity in which either Test #5 or #6 were met, that these "material participation" tests would come into play and prevent this REP from artificially creating a PIG.**

> **Comment:** Nevertheless, there is definitely a planning opportunity where there is a need for a "real estate professional" to create a source of passive income (either from annual net rental income, or from a Sec. 1231 gain on the sale of the underlying real estate). Namely, **just deliberately reduce your hours of involvement to below 750 in the year of sale, or involve yourself in other "non-real estate trade or business activities" so that the "> 50% test" is no longer being met. Then, your REP status is negated, and the general "per se" classification of rental activities being passive would come back into play.**

☞Lack of Sufficient Ownership Resulted in Realty Worker's Time Not Counting for PAL Material Participation Test (*Calvanico*, TC Summ. Op. 2015-64 (11/9/2015))

As this case demonstrates, some realty workers, due to their lack of at least a 5% stake in the company, will not be permitted to claim "real estate professional" status with regard to the passive loss exception and rental losses. Taxpayers are allowed to fully deduct rental losses if they spend over 50% of their time and more than 750 hours a year materially participating in "real estate trades or businesses." But, in order to count their time as employees working in a real estate trade or business, employees must own more than 5% of the company to count their hours on the job (i.e., when determining if more than half of their working hours are devoted to real estate). In this instance, a couple owned three rental units in a condo building. The husband was employed full-time as a real estate appraiser (i.e., "real estate T/B"), but he did *not* have an ownership interest in his employer. And, neither he nor his wife could prove that they spent enough time on the rentals by themselves to qualify as real estate professionals. Because he could *not* include his time spent as an employee in this real estate trade or business, the passive loss rules served to prevent the offset of their rental losses against either their active or portfolio income. **(Code §469; PALs)**

> **Comment:** It would *not* matter whether the couple could demonstrate "material participation" in the rental activity if the husband could *not* at least first satisfy the two-part test to be a "real estate professional" (REP).

☞750-Hour REP Test Not Satisfied by Couple Combining Hours (*Dunn*, TC Memo. 2022-112 (11/29/2022))

For purposes of the 750-hour "real estate professional" test under the passive loss rules, a married couple attempted to combine their respective hours involved with various rental activities. Although a couple can combine their hours for the "material participation" test, one of them alone must first satisfy *both* the 750-hour and >50% tests. The Service is increasingly calling into question large rental losses reported on **Schedule E**, especially those taken by taxpayers claiming to be “real estate professionals” when they otherwise have full-time *non-real estate* jobs. When questioned by the IRS, the couple submitted time logs showing they devoted 767 hours to their rental activity between them. In other words, neither of them *separately* the 750-hour test (let alone the >50% test) for being a REP. As a result, their rental losses were disallowed. **(Code §469; REP)**

☞**Employee in Real Estate Brokerage Business Fails REP Test**

In a fact pattern that might surprise practitioners, an individual worked full-time (i.e., > 2,000 hours/year) in a real estate brokerage firm. However, he owned less than 5% in the business (in fact, he owned nothing of the company and was merely an employee). Therefore, none of these hours as a rank-and-file-employee count toward the > 750-hour REP test. Nevertheless, this individual also owned a number of rental properties and kept meticulous records which indicated that about 800 hours were dedicated to these activities (and, a proper grouping election was made for purposes of the “material participation” test). So, the 750-hour REP test was met with these hours.

However, the key question then becomes whether he satisfy the > 50% of his time in all “trades or businesses” by his hours in “real estate trade or businesses.” This is where it becomes tricky. Namely, if his hours failed to count for the 750-hour test since he had no ownership stake in the real estate brokerage firm, they arguably would *not* count for the send > 50% time test. As a result, any rental income or loss with regard to his rental activities would be subject to the passive loss rules under **Code §469**. **(Code §469; Passive Losses)**

☞**Insufficient Records for “Real Estate Professional” Classification (*Hairston*, TC Memo 2019-104 (8/20/2019))**

The Tax Court agreed with the IRS that a taxpayer's calendars “did *not* provide enough proof” that he materially participated in 750 hours of service with regard to his various rental properties.

Background: Code §469(a) generally disallows a current deduction for a passive activity loss (PAL) incurred by an individual. Generally, a rental activity is treated as being *automatically* passive regardless of the taxpayer's actual participation in it. (**Code §469(c)(2)**) But certain rental activities undertaken by a taxpayer who satisfies the test for being a "real estate professional" are excepted from this rule. To qualify as a real estate professional, a taxpayer must, among other things, perform *more than 750 hours* of services during the tax year in “real property trades or businesses” (which includes rental activities) in which the taxpayer also *materially participates*. (**Code §469(c)(7)(B)(ii)**) Hours when a taxpayer is "on call" (e.g., available to speak to contractors who might have questions while the taxpayer is working on an unrelated job) do *not* count towards the 750-hour requirement because no services have in fact been performed. (***Moss*, 135 TC 365 (9/20/2010)**)

Facts: The taxpayer owned two rental properties. He was involved in various activities related to the properties including: performing maintenance on the property such as cutting grass and removing snow, remaining onsite while workers were performing major maintenance on the property, advertising the properties, fielding questions from prospective tenants, showing the properties to applicants, and screening applicants with credit reports and background checks. For the tax year in question, his expenses of maintaining the properties exceeded his income from the properties. Nevertheless, he deducted that net loss against his other income.

The taxpayer maintained a calendar for each rental property that purported to show the number of hours worked each day. The calendars included 360 separate entries and showed he performed 750 hours of service during that year. The IRS, however, disputed the number of hours worked and concluded that he did *not* "materially participate" in more than 750 hours of service. As a result, the IRS determined that the net loss was a PAL and *not* currently deductible.

Tax Court Decision: The Tax Court confirmed that the taxpayer "did *not* provide enough proof" to show he performed 750 hours of service. The Court found that the hours recorded on the calendars "lacked credibility" for several reasons. For example, every task recorded on the calendars, no matter how insignificant, was listed as having taken "at least one hour to complete." These included "36 entries for doing nothing more than receiving a rent payment, issuing a receipt for a payment, or depositing a check at the bank." And, there were 13 distinct one-hour entries for "paying mortgage." The Court found that this "inflationary pattern" was also found in calendar entries recording time that the taxpayer allegedly spent supervising contractors. He also recorded many hours during which he allegedly watched contractors work, including 33 hours while they "installed and cleaned carpet." During one week in December, he recorded another 40 hours "supervising" contractors who were painting the interior of one of the properties. More importantly, the Court did *not* think that that the time the taxpayer spent watching contractors qualified as actual work performed when the contractors were in fact doing the work. The Court concluded, citing ***Moss***, that he was at best "on call" to answer questions from the contractors and lock the house when they finished. So whether he spent 40 hours or one hour watching the painters, this was *not* time that could be counted toward the 750-hour REP test. **(Code §469; REP Test)**

☞**REP Status Difficult to Prove With Non-Real Estate T/B Full-Time Position (*Jones*, TC Summ. Op. 2017-6 (2/17/2017))**

Real estate professionals can overcome the automatic passive loss status accorded rental activities, if they spend over half their working hours and more than 750 hours a year materially participating in "real estate trades or businesses" as a broker, landlord, builder, etc. But, those taxpayers with *full-time* jobs in non-real estate trade or business positions will have a difficult time meeting these requirements, as shown in this instance. Here, the owner of an insurance firm who also owned 10 rental properties but he failed to prove that he spent more time on the rentals than in his insurance business. As a result, the Tax Court agreed with the IRS that his rental loss deductions should be disallowed. **(Code §469; REPs)**

Comment: Part-time workers have it somewhat easier in meeting the REP test, even if their other work is in a non-real estate related trade or business. For instance, a dentist who worked four afternoons a week, also owned four rental homes, for which he put in more than 1,000 hours during the year. And, since that was more than the time that he devoted to his dental practice, he qualified as a real estate professional and could write off the rental losses he incurred. (***Zarrinnegar*, TC Memo. 2017-34 (2/13/2017)**)

☞**IRS Continues to Contest REP Status When Taking Rental Losses (*Whoriskey*, TC Summ. Op. 2021-30 (8/23/2021))**

Real estate professionals are required to meet two separate and distinct tests in order to fall outside of rental activities being automatically classified as subject to the **Code §469** passive-activity loss rules and to be able to deduct their rental losses in full. They must spend over half their working hours and more than 750 hours a year materially participating in "real estate trades or businesses." And, the IRS has overwhelmingly been successful in court when challenging real-estate pro status. Here, a couple deducted a significant rental loss. The husband had a real estate license, but worked full-time as a firefighter, while the wife held down two jobs as a nurse. Lacking adequate records, neither the husband nor the wife could prove that they devoted enough hours to qualify as "real estate professionals." As a result, the write-off of their rental losses was denied (i.e., they ended up being suspended on Form 8582). **(Code §469; REP Status)**

Comment: Once is it shown that a taxpayer otherwise works full-time in a "non-real estate trade or business," it is going to be fairly difficult to prove that the 50% test mentioned above is being satisfied.

☞**PAL Material Participation Established Based on Cell Phone Records (*Tolin*, TC Memo 2018-29 (3/19/2018))**

An attorney was successful in challenging the IRS's determination that he was *not* a material participant in a horse breeding venture. It held that IRS was *not* "substantially justified" under **Code §7430** in its position that the attorney's losses were passive activity losses "once it received and analyzed voluminous cell phone records that showed his extensive participation." However, litigation costs were awarded at the statutory hourly rate, and *not* the $400 per hour rate the taxpayer sought for his "specialist" counsel. **(Code §469; PAL Losses)**

> **Comment:** The taxpayer had claimed ordinary losses from a side thoroughbred horse breeding and racing activity that were held to *not* be passive activity losses by the Tax Court (***Stefan A. Tolin*, TC Memo 2014-65 (4/9/2018)**). The taxpayer then petitioned the Tax Court to seek an award for litigation costs. His claim was upheld, in part, because after a certain date, the IRS' position was no longer justified. Nevertheless, the taxpayer was disqualified as the "prevailing party" under **Code §7430(c)(4)(E)** because the judgment of the court was more than the amount of the taxpayer's qualified offer. However, the taxpayer was treated as the "prevailing party" as of 12/1/09 because the IRS' position in the proceeding was no longer "substantially justified" after 11/30/09 since the IRS' attorney had received additional voluminous phone records that supported the taxpayer's position.

☞**Real Property Broker v. Mere Financier Eligible for Passive Activity "Real Estate Professional" Exception (CCA 201504010)**

The IRS has concluded that a real estate agent who facilitates bringing together buyers and sellers of real property will qualify as a "real estate professional" who is engaged in a real property brokerage trade or business as described in **Code §469(c)(7)(C)** of the passive activity loss rules. However, a mortgage broker who is merely a broker of financial instruments is *not* considered to be engaged in a "real property brokerage trade or business" (even if all of the loans involved real estate transactions). **(Code §469; REP)**

☞**Time Spent Preparing Home for Rental Not Counted in "Real Estate Professional" Test (*Smith*, TC Summ. Op. 2014-13 (2/19/2014))**

The time spent converting a home into a rental property does *not* count toward the 750-hour test needed to establish that a taxpayer is a "real estate professional" with regard to the automatic classification of rental activities as passive under **Code §469**. "Real estate professionals" are allowed to deduct their rental losses in full so long as they satisfy two time related tests. Namely, they must spend over 50% of their total working hours and at least 750 hours each year materially participating in real estate trades or businesses (which includes rental activities). In this instance, the taxpayer was a full-time software engineer and only worked part-time in his various residential real estate activities. Nevertheless, he spent over 1,000 hours fixing up his primary residence to make it ready for future rental purposes. But, because the home was *not* yet officially part of his rental business, the hours spent on renovations (i.e., leading up to its eventual rental) could *not* be counted when determining whether the time tests were met. **(Code §469; Real Estate Professional)**

☞**Time Driving to and from Rental Properties Counts Toward Real Estate Professional Status (*Leyh*, TC Summ. Op. 2015-27 (4/13/2015))**

The Tax Court has confirmed that real estate professionals that satisfy the following two "time tests" can fully deduct rental losses: They are required to spend over 50% of their total working hours and more than

750 hours each year materially participating in real estate activities. In this instance, the taxpayer lived about 45 minutes from her dozen rental properties and needed the time that she spent driving to and from the rentals during the year to get over the 750-hour annual time threshold which she did by providing the needed substantiation to satisfy both of time tests by including these commuting hours. **(Code §469; REPs)**

> **Comment:** Take a situation where a hurricane has impacted several rental properties in FL while the taxpayer resides in the mid-west. Needing a car to get around organizing repairs and buying supplies, he drives to FL. And, it takes several weeks before lining up the contractors for the repairs and supervising their execution. Given good records are kept, these are all hours that would count toward the 750-hour test. Or, a taxpayer owns a number of properties spread out across a major metropolitan area where traffic congestion results in many hours while checking on properties, collecting rents monthly, showing the premises to prospective renters, etc.

☞Time Spent in Investor Related Activities Ignored for PAL Real Estate Professional Test (*Padilla*, TC Summ. Op. 2015-38 (6/29/2015))

Taxpayers who spend over 50% of their total working hours (i.e., either as an employee, or as a self-employed independent contractor) and more than 750 hours each year materially participating in real estate activities can fully deduct rental losses as a "real estate professional." In this instance, the taxpayer's time log showed 764 hours spent with regard to five rental homes that he owned. But much of that was "investor-related time" (i.e., v. that of a typical landlord, at least in the eyes of the Tax Court), such as "research on refinancing and other business opportunities." Also, a real estate firm was hired to manage the properties (i.e., which serve to minimize the actual time that the taxpayer had to spend with regard to these rental properties). The Tax Court decided that these "investor-related" hours should *not* be counted for the REP test. As a result, he fell below the required 750-hour threshold. **(Code §469; Real Estate Professional)**

☞Excluded Gain on Sale of Former Residence Not Offset by Suspended Passive Losses (CCA 201428008)

A taxpayer bought a principal residence and used it as his principal residence for two years before converting it into a rental property. During the three years the house was rented, the taxpayer reported $30,000 in net losses, which were disallowed as passive losses under **Code §469(a)**. Within three years of renting the house (i.e., so as *not* to violate the 2-out-of-5-year rule for personal use), the taxpayer sold the property to an unrelated third party, realizing a net gain on the sale of $100,000 (without considering the $30,000 suspended passive losses). He then excluded the full $100,000 gain on sale under **Code §121(a)** (i.e., which provides for a maximum $250,000/500,000 gain exclusion on the sale or exchange of a "principal residence"). The IRS determined that under the facts of this case, because the $100,000 of gain realized was recognized upon the sale of the taxpayer's *entire* interest in a passive activity to an unrelated party, the **Code §469(g)(1)(A)** "disposition rule" applied. As a result, to the extent that the suspended passive activity losses exceeded any net income or gain for the tax year of the disposition from all other passive activities, the $30,000 losses would be treated as *not* being from a passive activity under **Code §469(g)(1)(A)**. Furthermore, because the $100,000 gain on the sale of the residence was excluded from the taxpayer's gross income under **Code §121**, it was *not* an item of passive activity gross income for purposes of **Code §469**. Therefore, the excluded gain from the sale did *not* result in any offset against the $30,000 suspended passive activity losses from the property. **(Code §469; PAL Disposition Rule)**

> **Comment:** This is a good result for the taxpayer since such losses will then still be available against other sources of taxable income (and, *not* be wasted against a gain that is already excluded).

Comment: Understand that there is no question that, as of the time of the sale of this property, it was a rental activity. So, any gain or loss would still be reported on **Form 4797**. And, had there been a loss, it would have been treated as a nonpassive Sec. 1231 ordinary loss and carried over to page one of the taxpayer's **Form 1040**. Also, the $30,000 of suspended passive losses on **Form 8582** would also have been freed up to offset, first, any other passive income sources and, then, any other "active" or "portfolio" income. But, since there was a gain on the sale (i.e., $100,000) which would have been treated as Sec. 1231 gain had the **Code §121** principal residence exclusion *not* been available, the $30,000 of suspended loss is simply available to offset other passive income, if any, and then, other "active" or "portfolio" income. Either way, this qualified as a "complete disposition" under the passive loss rules and the $30,000 of suspended losses would have been freed up regardless of any gain or loss on the underlying sale of the residence.

Code §475 - Mark-to-Market Election:

☞**Individual's Request to Make Late Mark-to-Market Election Denied (PLR 202150001)**

The IRS denied an individual's request to make a late mark-to-market election because he was found to have had "the benefit of hindsight" when he made his request. As a result, he failed to act "reasonably and in good faith."

Mark-to-Market Accounting Method: Under the mark-to-market accounting method, any security held at the end of the tax year is treated as sold (and then re-acquired) at its fair market value on the last business day of that year.

Electing Mark-to-Market Method: Code §475(f)(1) allows a taxpayer who is a securities trader (including a "day trader") to apply the mark-to-market accounting method to securities held in connection with their trading business. Generally, a taxpayer must make the mark-to-market election no later than the *unextended* due date of their original federal income tax return for the tax year *immediately preceding* the tax year the election will be effective (i.e., so, for the 2023 tax year, the election must have been made by 4/17/2023). A trader who fails to make a timely mark-to-market election may request permission to make a late election. But, to obtain permission to make a late election, a taxpayer must establish that:

1. They acted reasonably and in good faith, and

2. Granting permission to file a late election will *not* prejudice the government's interests.

A taxpayer is treated as *not* acting "reasonably and in good faith" if specific facts have changed since the due date for making the election that would make the election "advantageous to the taxpayer" (i.e., if the taxpayer has the benefit of hindsight and it would most likely benefit them, at least from a tax standpoint). (**Reg. §301.9100-3(b)(3)(iii)**)

The government's interests are "prejudiced" if allowing the taxpayer to make a late election would result in the taxpayer having a *lower* tax liability for all tax years affected by the election than the taxpayer would have had if the election was made timely. (**Reg. §301.9100-3(c)**)

IRS Ruling: The IRS denied the individual's request to make a late mark-to-market election because he did *not* act "reasonably and in good faith" and granting his request to file a late mark-to-market election "would prejudice the government's interests." The key factor was because he was able to determine that making the election was advantageous to him *before* making the election. In addition, since a mark-to-market election is an "accounting method regulatory election" that requires a **Code §481(a)** adjustment, the government's interests were deemed to be prejudiced because the individual failed to present "unusual and compelling circumstances" that justified granting his request to make a late mark-to-market election. **(Code §475; Mark-to-Market Election)**

Comment: Before even considering making this election, an individual has to prove that they are in fact in the business of buying and selling securities which is extremely difficult.

Code §529 - Qualified Tuition Programs:

Code §901 - Foreign Tax Credit:

Foreign Tax Credits Only Offset Tax on Foreign-Source Income (*Bassily*, TC Summ. Op. 2021-20 (7/19/2021))

U.S. taxpayers are permitted to claim a credit for income taxes paid to other countries with regard to any "foreign-source income" otherwise reported on their **Form 1040**. **Form 1116** is used to claim this credit. This case involved a taxpayer who owned brokerage accounts along with his son. The father here attempted to claim the credit for foreign taxes paid from the accounts against his other U.S.-source income, while it was the son who actually reported *all* of the foreign income. The Tax Court affirmed that a foreign tax credit is allowed only to the extent it was paid or accrued with respect to income from non-U.S. sources. But since the taxpayer had no foreign income reported on his return, his foreign tax credit is denied (although the son would be able to claim this credit on his personal return, given he was also named on the accounts and could assert that he had indeed paid some foreign taxes on the share of the income that he reported). **(Code §901; FTC)**

Foreign Tax Credit Cannot Offset Medicare Surtax on NII (*Toulouse*, 157 TC No. 4 (8/16/2021))

The U.S. foreign tax credit cannot be used to offset the 3.8% net investment income surtax (i.e., as shown on **Form 8960**) in the case of a U.S. citizen living abroad in France. She attempted to claim the credit on her U.S. return for income taxes she paid in France and Italy on this net investment income. The Tax Court confirmed that the U.S. tax code does *not* allow foreign tax credits to offset the NII surtax (even though state and local taxes would offset this income when calculating the surtax on **Form 8960**). Furthermore, the tax treaties that the U.S. has with France and Italy do *not* provide relief. **(Code §901; FTC)**

Code §1012 - Basis of Property - Cost:

☞**Case Provides Good Overview When Selling Different Blocks of Stock (*Turan*, TC Memo. 2017-141 (7/17/2017))**

When selling stock through a brokerage account, taxpayers need to keep in mind the basis rules, especially where several blocks of a company's stock with different bases have been purchase over an extended period of time. Generally speaking, if you sell a block of shares purchased at different times, you are treated as selling the *earliest-acquired* shares first. However, the IRS rules permit an election for investors whereby they can specifically identify the shares they want sold, which tend to be the shares with the highest tax basis in order to minimize gain or maximize loss on the sale. But, to use this method, the taxpayer must inform their broker the exact shares they want to sell and receive prompt written or e-mail confirmation that these directions were followed. A "standing order," such as one to always sell with the highest basis, also would be effective. In this instance, the taxpayer learned a lesson the hard way. He failed to instruct his broker to use the specific identification method when he sold some publicly traded stock that he acquired at different times. So the broker used the default FIFO rule and treated him as selling the oldest shares first. **(Code §1012; Stock Basis)**

> **Comment:** The taxpayer's brokerage firm (Scottrade) uses the FIFO method to determine the tax basis and calculate gains or losses unless a client directs otherwise. Scottrade issues a monthly transaction statement to its clients. This statement includes a conspicuous notification alerting Scottrade's clients to the firm's default use of the FIFO method. The notification informs those of Scottrade's clients who wish to use a different method for determining basis that they may do so by directing Scottrade to do so.

Code §1031 - Like-kind Exchanges:

☞IRS Issues Like-kind Exchange Final Regs (TD 9935)

The IRS has issued final regs to implement recent statutory changes to **Code §1031** regarding like-kind exchanges. The final regs amend the current like-kind exchange regs to add a definition of "real property" to implement statutory changes limiting **Code §1031** treatment to like-kind exchanges of only real property (i.e., v. tangible personal property). The final regs also provide a rule addressing a taxpayer's receipt of *personal* property that is "incidental to real property" the taxpayer receives in an otherwise qualifying like-kind exchange of *real* property.

> **Comment:** Prior to the enactment of the **TCJA**, **Code §1031** "like-kind exchanges" were *not* limited to real property. As a result, there was no need to provide a definition of "real property" for purposes of that Code section. But now that distinction is important since the receipt of any "boot" which would now include personal property (i.e., other than personal property which is considered to be only "incidental" under the "15% test" outlined below).

> **Final regs:** The final regs adopt the proposed regs with the following modifications.

- Property classified as real property: Prop. Reg. §1.1031(a)-3(a)(1) provided that State or local law definitions were, in general, *not* controlling for purposes of determining whether property is "real property" for **Code §1031** purposes. The final regs *reverse* this and provide generally that property will be considered "real property" for purposes of **Code §1031** if, on the date it is transferred in an exchange, that property is classified as real property under the law of the State or local jurisdiction in which that property is located (i.e., "State and local law test"). The State and local law test applies to *both* tangible and intangible property.

The Preamble to **TD 9935** provides a summary of how property is classified under the final regs. Property is classified as "real property" for purposes of **Code §1031** if the property is:

i. So classified under the State and local law test, subject to certain exceptions;

ii. Specifically listed as real property in the final regs; or

iii. Considered real property based on all the facts and circumstances under the various factors provided in the final regs.

- Purpose or use test: The proposed regs considered the function of property in determining whether the property is real property (i.e., "purpose or use test"). In particular, neither tangible property, such as machinery or equipment, nor intangible property, such as licenses or permits, was classified as "real property" under the proposed regs if the property "contributed to the production of income unrelated to the use or occupancy of space," irrespective of any other factor under the proposed regs.

The final regs *eliminate* the "purpose or use test" for tangible property. Consequently, with regard to tangible property, if such property "is permanently affixed to real property and will ordinarily remain affixed for an indefinite period of time," the property is generally an "inherently permanent structure" and therefore real property for **Code §1031** purposes, irrespective of the "purpose or use" of the property or whether it "contributes to the production of income." A "structural component" likewise is characterized as real property under the final regs if it is integrated into an "inherently permanent structure," regardless of whether the structural component contributes to the production of income. As a result, under the final regs, items of machinery and equipment are characterized as real property if they comprise an inherently permanent structure, a structural component, or are real property under the State or local law test.

> **Comment:** The final regs provide that if an "affixation is reasonably expected to last indefinitely based on all the facts and circumstances, the affixation is considered permanently affixed."

- Co-op housing corporation stock and land development rights: The final regs specifically list stock in a cooperative housing corporation and land development rights as intangible assets that will be treated as "real property.

- Licenses and permits: The final regs provide that a license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold, an easement, or a similar right generally is an interest in real property and thus is "real property" under **Code §1031**.

- Incidental property rule: Personal property is considered to be "incidental to real property" acquired in an exchange if:

i. In standard commercial transactions, the personal property is typically transferred together with the real property, and

ii. The aggregate fair market value of the incidental personal property transferred with the real property does *not* exceed 15% of the aggregate fair market value of the replacement real property (i.e., "15-percent limitation"). (**Reg. §1.1031(k)-1(c)(5)(I)**)

The final regs clarify that the "15-percent limitation" is calculated by comparing the value of all of the "incidental properties" to the value of all of the "replacement real properties" acquired in the *same* exchange. **(Reg. §1.1031(k)-1(g)(7)(iii)(B)**) For example, assume a taxpayer acquires an office building (Building 1) with office furniture, and a second office building (Building 2) with no personal property. Under the final regs, the taxpayer does *not* exceed the "15-percent limitation" if the value of the furniture is 15% or less of the total value of Building 1 *and* Building 2, even if the value of the furniture exceeds 15% of the value of just Building 1. **(Code §1031; LKEs)**

☞**Like-kind Exchange Treatment Denied for Depreciation Recapture Gain (*Gerhardt*, 160 TC No. 9)**

The taxpayers sold rental property consisting of land, hog buildings and equipment. The hog structures and the equipment were fully depreciated and therefore subject to recapture under **Code §1245** as ordinary income. Like-kind real property was eventually acquired within the necessary time limits. Nevertheless, even though the exchange met the reinvestment deadlines under **Code §1031**, the Court agreed with the IRS that the couple should *not* be allowed to defer the gain from the sale because the gain was *fully attributable* to Section 1245 recapture. Instead, that gain had to be treated as ordinary income in the year of the sale. **(Code §1031; LKEs)**

> **Comment:** Keep in mind that the hog structures were classified as MACRS 10-year "single-purpose agricultural structures" and thus eligible for 100% bonus depreciation, along with the equipment. Furthermore, even though these structures were "real estate" and thus eligible for like-kind exchange treatment, any ordinary income due to Sec. 1245 depreciation recapture (i.e., accelerated depreciation had been taken on these assets due to either bonus depreciation, Sec. 179 immediate expensing or the use of the 150% DB method) would *not* qualify for Sec. 1031 LKE treatment. And, of course, after the passage of the **TCJA**, tangible personal property such as equipment would also *not* qualify at all for Sec. 1031.

> **Comment:** When accelerated depreciation is used on commercial real estate (i.e., due to either bonus depreciation, Sec. 179 immediate expensing or the use of the 150% DB method), **Code §1250** causes *any* gain due to these write-offs to be subject to Sec. 1245 depreciation recapture and listed as ordinary income on **Form 4797** (i.e., which then flows over to page one of the return as "Other Income").

> **Comment:** If this had instead been residential v. commercial real estate and an accelerated depreciation method had been used (e.g., pre-1987 real estate was being exchanged), then only the *excess depreciation* under that accelerated method (e.g., 175% DB for ACRS real estate placed into service from 1981 through 1986) over what would otherwise been allowed under the S/L method would be subject to recapture as ordinary income (and, thus, ineligible for LKE treatment under **Code §1031**). But, for example, since the longest recovery period for ACRS real estate was 19 years, this becomes a moot issue for dispositions after 2005 (i.e., 1986 + 19-year ACRS recovery period).

☞**Exchange of Permanent Water Rights for Land Treated as LKE**

A ranch owner possessed the *indefinite* right to divert an amount of water from a nearby river annually for irrigation. In this instance, the IRS privately ruled that the exchange of the water rights for a fee simple interest in real property held for productive use in a business or for investment qualifies as a **Code §1031** like-kind exchange. The key factor was that the water rights were treated as a "permanent interest in real property." **(Code §1031; LKEs)**

> **Comment:** The court did state that the result would have been different if the water rights being exchanged "were temporary and *not* perpetual." In 2002, a district court ruled that a swap of 50-year water rights for land was taxable.

Code §1221 - Capital Asset:

☞**Capital Loss on Sales of Realty Held for Investment (*Musselwhite*, TC Memo. 2022-57 (6/8/2022))**

Due to the lack of real estate development activities costs a taxpayer was denied ordinary loss treatment. The taxpayer here owned four partially developed real estate lots, which he sold at a $1 million loss. The loss had to be treated as a capital loss according to the Tax Court because he held the lots for investment and *not* for sale in the ordinary course of his business. A key factor was that he failed to make any improvements to the parcels before selling them. Also, he was an a full-time attorney and *not* a real estate developer based on multiple factors such as his infrequent sales of realty. **(Code §1221; Capital Loss)**

☞**Gain on Sale of Land by Developer Treated as Capital Gain (*Sugar Land Ranch Development, LLC*, TC Memo 2018-21 (2/22/2018))**

The Tax Court rejected the IRS's recharacterization of gain on the sale of real estate properties as ordinary income and found that the LLC correctly treated the gain as capital gain. The LLC was established to acquire real estate and develop it into single family residential lots and commercial tracts. But, due to the effects of the sub-prime mortgage crisis on the local housing market, the LLC believed it would be unable to develop, subdivide, and sell the lots. Therefore, the LLC decided to hold the property as an investment and sell when the market improved. As a result, the Court concluded that the LLC was *not* engaged in the development business for the three years prior to the sale and held the real estate for investment purposes. Therefore, the properties were *not* sold as part of the LLC's ordinary course of business.

The 5th Circuit (the court to which this case would be appealable) held that the three principal questions to be considered in deciding whether gain is capital in character are:

1. Was taxpayer engaged in a trade or business, and, if so, what business?

2. Was the taxpayer holding the property primarily for sale in that business? and

3. Were the sales contemplated by taxpayer ordinary in the course of that business? (***Suburban Realty Co v. U.S.*, 45 AFTR 2d 80-1263 (5th Cir., 4/7/1980)**)

In doing its analysis, the 5th Circuit would most likely consider a number of factors in this determination:

- The frequency and substantiality of sales of property;

- The taxpayer's purpose in acquiring the property and the duration of ownership;

- The purpose for which the property was subsequently held;

- The extent of developing and improving the property to increase the sales revenue;

- The use of a business office for the sale of property;

- The extent to which the taxpayer used advertising, promotion, or other activities to increase sales; and

- The time and effort the taxpayer habitually devoted to the sales.

And, of these factors, "frequency and substantiality of sales" is the most important factor. **(Code §1221; Dealer v. Investor)**

Code §1231 - Sec. 1231 Losses:

☞**Sale of Renovated Mansion Resulted in Capital, Not Ordinary, Loss (*Keefe*, 126 AFTR 2d 2020-5076 (2nd Cir., 07/17/2020))**

The 2nd Circuit *affirmed* the Tax Court's decision that a historic waterfront mansion a couple renovated, but never rented out, was a capital asset. Therefore, the couple was entitled to a capital, *not* an ordinary Sec. 1231, loss when they sold it.

Comment: Even though the couple did try to rent out the home over a span of several years, the Court was *not* convinced that they successfully converted what had been a capital asset simply held for investment purposes and potential future appreciation into a Sec. 1231 asset. More importantly, though, the 2nd Circuit weighed in on what tests it would look at regarding whether a rental property met the "Sec. 162 trade or business test" which would also be critical for purposes of the Sec. 199A deduction.

Background: Capital assets do *not* include real property used in a taxpayer's trade or business. (**Code §1221(a)(2)**) Real estate rental is considered a taxpayer's "trade or business" if the taxpayer engages in "regular and continuous" activity in relation to renting real property. (***Alvary***, **9 AFTR 2d 1633 (2nd Cir., 5/18/1962)**) To determine whether a taxpayer is engaged in regular and continuous activity in relation to renting real property, the courts look to the following:

1. Whether the taxpayer (or the taxpayer's agent) performs maintenance and repairs;

2. Whether the taxpayer employs labor to manage the property or provide tenant services; and

3. Whether the taxpayer purchases materials, collects rent, and pays expenses.

Losses resulting from the sale of property that is *not* a capital asset are considered ordinary losses and are fully deductible. (**Code §65**; **Code §165(a)**) On the other hand, capital losses in excess of any capital gains that the taxpayer might otherwise have, are deductible subject to an annual $3,000 limitation. (**Reg §1.1211(b)**) (**Code §1231**; **Rental Losses)**

Code §1400Z - Qualified Opportunity Funds:

☞**IRS Letters to Selected Taxpayers with Qualified Opportunity Fund Investments** (**IR 2022-79**)

The IRS recently began sending letters to taxpayers who may need to provide the IRS with more information about their QOF investments.

Comment: How prevalent are these funds? Are our clients taking advantage of them? What was the impact of the 2020 U.S. census?

IRS Letters: The IRS will be sending **Letter 6501, Qualified Opportunity Fund (QOF) Investment Standard**, to certain taxpayers who attached to their return **Form 8996, Qualified Opportunity Fund**. Meanwhile, **Letter 6401** will ask these taxpayers to provide information needed to support the required "annual certification of investment standard." This is because such information is missing, invalid, or the calculation is *not* supported by the amounts previously reported to the IRS. Taxpayers that want to maintain their QOF status will need to respond to this letter promptly to meet the certification requirement.

Comment: The IRS may refer for examination an entity that receives **Letter 6501** and fails to respond. In addition, investors who elected to defer tax on eligible gains invested in that entity may also be subject to examination.

Additional IRS Letters: The IRS may also send these taxpayers either:

- **Letter 6502, Reporting Qualified Opportunity Fund (QOF) Investments**, or

- **Letter 6503, Annual Reporting of Qualified Opportunity Fund (QOF) Investments**.

These letters notify taxpayers that certain information required by **Form 8997, Initial and Annual Statement of Qualified Opportunity (QOF) Investments**, that (1) Is missing or invalid, or (2) The taxpayer "may *not* have properly followed the requirements to maintain their qualifying investment in a QOF with the filing of the form." **(Code §1400Z-2; QOFs)**

> **Comment:** The bottom line is that taxpayers intending to maintain an investment as a QOF should file an amended return or an **Administrative Adjustment Request (AAR)** with a properly completed **Form 8997** attached. Otherwise, taxpayers that fail to act after receiving a letter may *not* have a qualifying investment in a QOF (i.e., meaning a complete loss of the deferral/exclusion on previous capital gains).

> **Comment:** Given the relative unregulated nature of these QOZ funds, some major gains that our clients believe they have deferred (and, eventually, will not have to pay any tax on them) might be at substantial risk of losing there special tax status.

Code §6038D - Foreign Asset Reporting:

☞**Foreign Bank Account Reporting Reminder**

The IRS is reminding all U.S. citizens and resident aliens with an interest in, or signature or other authority over, foreign financial accounts, whose total value exceeded $10,000 at any time during the tax year, that they must file electronically with the Treasury Department a Financial Crimes Enforcement Network (FinCEN) **Form 114 Report of Foreign Bank and Financial Accounts (FBAR)** by April 15th (i.e., with automatic extensions until Oct. 15th). **(Code §6038D; Foreign Asset Reporting)**

> **Comment:** Even though the FinCen Form 114 is due at the same time as Form 1040, it is still a separate filing with the Treasury Department. For more detailed information, go to the Treasury **website**.

> **Comment:** One of the key factors that the IRS looks to when assessing "willfulness" for a taxpayer's failure to report such holdings is the question on Schedule B which specifically asks whether signatory authority over a foreign bank account is held by the taxpayer.

> **Comment:** The IRS has another resource in its efforts for uncovering offshore accounts. Now, foreign bank reporting of U.S.-owned accounts has commenced. Under the **Foreign Account Tax Compliance Act**, which was enacted in 2010, foreign banks and other foreign financial institutions must annually report to the IRS on accounts of over $50,000 that are owned by U.S. persons. Those that fail to do so face a 30% withholding tax on certain U.S.-source payments made to them. To enforce FATCA, the Service has also entered into disclosure pacts with many countries, whereby the foreign financial institutions disclose data on U.S. account owners to their own governments, which will then provide the information to the IRS. After years of delay, this new reporting regime is expected to soon be in full swing.

Code §6331 - IRS Levies

☞**Husband's IRA Garnished to Compensate Victims of Wife's Crimes (*Berry*, No. 19-20050, (5th Cir., 2/28/2020))**

A husband's IRA can be garnished to pay restitution to the victims of his wife's crimes. The wife pled guilty to various crimes after she stole funds from her employer. As part of her sentence, she was ordered to pay restitution of more than $2 million. To enforce the order, the government sought to garnish *not* only her IRAs but also IRAs belonging to her husband. The couple argued that the government had no legal right to tap his IRAs, but an appeals court disagreed. **(Code §6331; IRS Levy)**

Code §6651 - Failure to File or Pay Tax:

☞ **Reliance on Preparer No Excuse for Avoiding IRS Penalties (*Oosterwijk v. U.S.*, Memo. (D.C., Md., 1/27/2022)) & (*Lee v. U.S.*, 8:21-cv-01579 (D.C., Fla., 6/30/2021))**

These cases have continued to demonstrate that relying on a preparer to file a return is *not* enough to escape an IRS imposed penalty. And, it makes no difference whether in this era of electronic v. paper filing of one's tax returns. These two recent cases drive home the point. In the first instance, a couple relied on their CPA to e-file **Form 4868** to extend the filing date for their personal return and have the taxes due automatically debited from their account. But the preparer failed to complete the e-filing process. When the nonfiling was ultimately discovered, the couple filed a paper extension request and sent a check to IRS for the taxes due. The District Court in Maryland agreed with the IRS that they owe the failure-to-file penalty. In another case, the taxpayer was assured that his preparer e-filed his personal returns for the 2014-16 tax period, even after the taxpayer signed **Form 8879, IRS e-file Signature Authorization**. But, when it was discovered that the preparer failed to file the returns, the IRS imposed the failure-to-file tax and failure-to-pay penalties on the taxpayer for the tax years in question. Furthermore, the Florida district court agreed that the Service did *not* have to abate the penalties. **(Code §6651; IRS Penalties)**

☞ **Taxpayers Barred from Relying on IRS-Provided Advice to Avoid Penalties (*Peak*, TC Memo. 2021-128 (11/10/2021))**

Relying on an IRS phone operator's incorrect advice is *not* a sufficient reason so as to avoid a tax penalty. Here, an individual contacted the IRS seeking assistance in reporting retirement payouts he had received. He then followed the advice given him by an IRS operator, which turned out to be incorrect. The Tax Court agreed with the IRS that the individual owed tax as well as a penalty. As affirmed in a number of cases, "incorrect advice from an IRS worker is *not* law, nor does it bind the agency or the courts." **(Misc.; IRS Advice)**

Code §6662 - Underpayment Penalty:

☞ **Failure to Review Return Resulted in Costly Penalty (*Busch*, TC Bench Order No. 14085-20S (2/25/2022))**

Failing to review their **Form 1040** before electronically filing it cost the taxpayers severely in the form of a 20% substantial understatement penalty. The couple used tax software to prepare and file their return without realizing that the software recognized only "whole-dollar amounts." They inputted an amount for mortgage interest of $21,201.25, but the deduction on the filed return showed up as $2,120,125, which resulted in a huge refund. Instead of returning the excess funds to the IRS immediately, they waited until the Service audited them. They agreed that they owed more tax but disputed the penalty, claiming the error "was an honest mistake." But the Tax Court sided with the IRS that the discrepancy was "simply too large and should have been caught if the couple had only reviewed the return before e-filing." **(Code §6662; Underpayment Penalty)**

Code §7201 - Attempt to Evade or Defeat Tax

☞**Son Liable for Helping Dad Evade Taxes (*Bontrager*, 151 TC No. 12 (12/12/18))**

Even though the tax due was *not* that belonging to the son, the Tax Court here nevertheless held him to be liable since he was instrumental in assisting his father to evade the taxes in the first place (i.e., "transferee liability"). The key finding by the court was that restitution in federal criminal tax cases applies when there is a failure to pay "any tax" that is otherwise imposed under the tax statutes. In other words, it is *not* necessary that the tax be specifically imposed on the person ordered to pay the restitution. **(Code §7201; Tax Evasion)**

Code §7403 - Action to Enforce Lien or Subject Property to Payment of Tax

☞**Service Allowed to Foreclose on Jointly-Owned Properties to Satisfy Husband's Tax Debts (*Jackson*, Case No. 3:16-CV-05096-BCW (DC MO, 1/30/2019))**

The Court agreed that the IRS is entitled to foreclose on four properties that were jointly owned by the spouses and which were subject to federal tax liens due to outstanding tax debts owed solely by the husband. The IRS sought to sell the properties and disburse the funds in the following order: (1) Pay its appraisal specialists for the administrative costs of the sales; (2) Pay any outstanding property taxes; (3) Pay to the wife one-half of the remaining proceeds; and (4) Satisfy the husband's outstanding tax debts. The wife objected and insisted that she should be paid first her one-half share of any proceeds. But, the Court decided that the above ordering rules where the correct manner in which to distribute the proceeds. **(Code §7403; Tax Liens)**

Code §7701 - Joint Return:

☞**Without Wife's Consent Joint Return Filed During Divorce Proceedings Invalid (*Edwards*, TC Summary Opinion 2017-52 (7/17/2017))**

A purported joint return filed by a taxpayer for himself and his soon-to-be ex-wife was held to be invalid because it was filed without her consent. As a result, the taxpayer's proper filing status was married filing separate. Although the taxpayer and his wife had discussed filing a joint return and had done so in the past, there was no actual agreement to file jointly, and the wife's actions indicated that she did *not* know that a joint return had been filed on her behalf. However, the Court declined to impose accuracy-related penalties, finding that the taxpayer acted reasonably and in good faith at the time the return was filed. **(Code §7701; Joint Returns)**

Joint Return Requirements: Married filing jointly status does *not* apply to a return unless both spouses intend to make a joint return. (***Jones v. Commr.*, 13 AFTR 2d 1821 (4th Cir., 1964)**) However, although both spouses are required to sign the joint return, the failure of one spouse to sign does *not* necessarily negate the intent to file a joint return by the non-signing spouse. (***Estate of Campbell*, 56 TC 1 (1971)**) Whether an income tax return is a joint return or a separate return of the other spouse is a question of fact. In determining whether a non-signing spouse intended to file a joint return, courts have considered factors including:

1. Whether the returns were prepared pursuant to an established practice of preparing and filing a joint return;

2. Whether the non-signing spouse failed to object to the filing of a joint return;

3. Whether an affirmative act was taken indicating an intention to file other than jointly;

4. Whether one spouse entirely relied on the other spouse to file returns;

5. Whether the spouse examined returns presented for a signature;

6. Whether separate returns were filed;

7. Whether the returns included the income and deductions of the non-signing spouse, and

8. Whether the non-signing spouse was aware of the contents of the purported returns.

INDIVIDUAL TAXATION - CONSULTING ISSUES:

Miscellaneous:

☞**Whose Name Should Be Listed First on Joint Returns?**
A new report states that for heterosexual couples, men were listed first 88% of the time on 2020 joint returns. That percentage is down from 97.3% on 1996 returns. Men are more likely to be listed first on returns of older couples and on returns in which the husband earns more money than his spouse. Gender norms and who takes the lead in doing or preparing the couple's taxes are also factors. Taxpayers residing in Iowa have the highest percentage of the husband's name shown first on the joint return, while D.C. has the lowest. The **Form 1040** instructions advises spouses to enter the names and SSNs in the *same* order as in the previous year. As a result, if the husband's name was first on the 2022 return, it should also be listed first on the 2023 return filed next year, and vice versa. Changing the order can possibly lead to delays in IRS processing of the return. **(Misc.; MFJ Returns)**

> **Comment:** If estimated payments on being submitted on **Form 1040-ES**, it would be advisable to be consistent of the *same* spouse's name and SSN as that used for the filing of their joint return.

☞**Critical Tax Issues for Separating or Divorcing Couples**
The IRS has just issued a **"Tax Tip"** which addresses the situation when couples decide to either separate or divorce and how this change in their relationship status affects their tax situation. The IRS considers a couple married for tax filing purposes until they get a final decree of divorce or separate maintenance. And this determination is made as of the last day of the tax year (i.e., Dec. 31st).

Update Tax Withholding: When a taxpayer divorces or separates, they usually need to update their proper tax withholding by filing with their employer a *new* **Form W-4, Employee's Withholding Certificate**. If they receive alimony, they may have to make estimated tax payments, but this would only be for divorce decrees issue *before* 2019 since alimony for decrees issued in 2019 or later is nontaxable. Taxpayers can also figure out if they are withholding the correct amount with the **Tax Withholding Estimator** on IRS website.

Alimony and Separate Maintenance Payments: As mentioned above, the treatment of alimony or separate maintenance payments is dependent upon when the divorce decree was issued.

- Amounts paid to a spouse or a former spouse under a divorce decree, a separate maintenance decree or a written separation agreement will correspondingly be treated as alimony or separate maintenance for federal income tax purposes.

- Certain alimony or separate maintenance payments (i.e., with decrees issued *before* 2019) are deductible by the payer spouse, and the recipient spouse must include these amounts in income.

Rules Related to Dependent Children and Support: Generally, the parent with custody of a child is entitled to claim that child on their tax return (i.e., for purposes of tax credits such as the child tax credit and the dependent care credit). If instead the parents split custody equally and are *not* filing a joint return, they will have to decide which parent claims the child. But if the parents cannot agree, taxpayers should refer to the "tie-breaker rules" in **IRS Pub. 504, Divorced or Separated Individuals**. Child support payments are *not* deductible by the payer and therefore are *not* taxable to the payee.

Not all payments under a divorce or separation instrument (i.e., including a divorce decree, a separate maintenance decree or a written separation agreement) are alimony or separate maintenance. For instance, alimony and separate maintenance does *not* include:

- Child support
- Noncash property settlements (i.e., whether in a lump-sum or installments)
- Payments that are the ex-spouse's part of community property income
- Payments to keep up the payer's property
- Use of the payer's property
- Voluntary payments

One of the key issues is that child support is never deductible (i.e., regardless of when the divorce decree was granted) and therefore does *not* have to be included in the recipient's gross income. Additionally, if a divorce or separation instrument provides for alimony and child support and the payer spouse pays less than the total required, the payments are considered to be applied to child support first with the result that only the remaining amount is considered to be alimony.

Recording Property Transfers: Usually, if a taxpayer transfers property to their spouse or former spouse because of a divorce, under **Code §1041** there is no recognized gain or loss on the transfer. And, if the transfer is pursuant to a decree, there is no need to report the transaction on a **Form 709** gift tax return.

> **Comment:** More detailed information can be found in **IRS Topic No. 452 Alimony and Separate Maintenance**.
>
> **Comment:** Although FMV is paid to buy out an ex-spouse's interest in marital property, there is *not* the normal basis rules where the cost paid will now become the basis of the property received.
>
> **Example: "Buying Out Ex-spouse's Interest in Former Marital Home"**
> Lisa and Mike originally bought their home for $125,000. At the point that the principal balance was $100,000, they decided to upgrade the kitchen and master bedroom and borrowed an additional $120,000 to do these projects. They then decide to get divorced shortly thereafter when the principal balance on the mortgage was $220,000 and the house was worth $370,000. Lisa then borrows an additional $75,000 (i.e., 50% x $150,000 of equity in the home) to buy out Mike's portion, resulting in $275,000 now being owed on the home.
>
> Even though Lisa has just paid her ex-husband Mike $75,000 for his interest, her basis of $220,000 is *not* stepped up to $295,000. And though **Code §121** will permit Lisa to exclude up to $250,000 of gain on the sale of her principle residence, her potential gain will be calculated using this $220,000 basis. **(Misc.; Divorce)**

☞**Exclusion of Gain on Home Sales after Divorce**

It is not unusual for an ex-spouse to continue co-owning the former marital residence for an extended period of time after the divorce. A key issue arises when more than three years have passed since the other ex-spouse has lived in the home. Namely, the "nonresident ex" will now fail to satisfy the two-out-of-five-years “use test” (i.e., even though they will continue to meet the “ownership test”). As a result, when the home is eventually sold, the nonresident ex's share of the taxable gain will fail to qualify for the **Code §121** $250,000 gain exclusion. Nevertheless, this unintended tax trap can be easily be avoided with some advance planning.

If you are representing the “nonresident ex-spouse,” the key is to have the divorce papers stipulate that, as a specific condition of the divorce agreement, the client's former spouse is only allowed to continue occupying the home until the kids reach a certain age or for a specified number of years (or, whatever the two parties can eventually agree upon). At the end of that period of time, it is then agreed upon that the home can either be put up for sale with the proceeds split per the divorce agreement, or one of the ex-spouses will otherwise be entitled to buy out the other's share for an agreed-upon price.

Under **Reg. §1.121-4(b)(2)**, this type of advance planning results in your client, as the “nonresident ex-spouse,” to receive "credit" for the other ex-spouse's continued use of the property as a principal residence. As a result, when the home is eventually sold, the nonresident ex-spouse would nevertheless be treated as satisfying the two-out-of-five-years “use test” as a principal residence and thereby qualify for up to the $250,000 gain exclusion on their share of the subsequent gain. **(Code §121; Home Gain Exclusion)**

> **Comment:** Even though this planning point should be familiar to divorce attorneys, it is not unusual to see this type of language missing from the final divorce agreement with the result that, if the former marital residence is *not* sold within three years, the potential $250,000 gain exclusion is wasted for the “nonresident ex-spouse.”

☞**Using Durable Power of Attorney v. Form 2848 in Tax Matters**

Normally, a taxpayer is required sign a **Form 2848, Power of Attorney and Declaration of Representative**, in order to allow a third-party to represent them in a tax matter with the IRS. Furthermore, this representative must also have certain professional credentials such as being any attorney or a CPA or EA. In some cases, however, a taxpayer is unable to complete and sign a **Form 2848** because they may have become physically or mentally incompetent. According to the IRS, the key is to “plan ahead.” One solution might be to use a "durable power of attorney" (i.e., often used for estate planning or other purposes) to overcome a legally incompetent taxpayer's inability to complete a **Form 2848**.

Durable powers of attorney created for estate planning or other purposes give your designated agent or "attorney-in-fact" authority to make healthcare and financial decisions on your behalf. The word "durable" means the power of attorney has “staying power” and, as a result, will remain in effect even if you later become incompetent. Nevertheless, the durable power of attorney must be created *before* you become physically or mentally incompetent. For a durable power of attorney to work for federal tax matters, however, specific information required under the Code and regulations needs to be included. The requirements related to use of durable power of attorneys in federal tax matters are outlined in **Reg. §601.503(b)**, which can also be found in **IRS Pub. 216**.

When preparing a durable power of attorney certain key requirements must be met or it may *not* be sufficient to authorize your agent to act for you in tax matters in front of the IRS. In fact, your agent or tax professional may also have to be designated a guardian or similar fiduciary, which is typically done by a state court and can be a lengthy process. Once your agent is designated a guardian or similar fiduciary, they would then have to file an additional form (i.e., **Form 56**) with the IRS that informs the IRS of the fiduciary relationship. **(Misc.; Power of Attorney)**

For more information about using durable powers of attorney as a substitute for **Form 2848** and also about **Form 56**, the following website links below can be useful:

- National Taxpayer Advocate Blog: **When to Use a Durable Power of Attorney to Authorize Representation Before the IRS**

- IRS Office of Professional Responsibility: **Can You Use that Durable Power of Attorney before the IRS? Form 2848 vs. Durable Power of Attorney**

- **Form 2848, Power of Attorney and Declaration of Representative**, and **Instructions for Form 2848**

- **IRS Pub. 216, Conference and Practice Requirements**

- **About Form 56, Notice Concerning Fiduciary Relationship**

> **Comment:** Keep in mind that there are different types of third-party **authorizations** so as to enable someone other than the taxpayer to discuss their affairs with the IRS. These would include the following options: (1) **Power of Attorney** - Allows someone to represent a taxpayer in tax matters before the IRS. With this authorization, the representative must be an individual authorized to practice before the IRS; (2) **Tax Information Authorization** - Appoints a person to review or receive a taxpayer's confidential tax information for the type of tax for a specified period; (3) **Third Party Designee** - Designates a person on the taxpayer's tax form to discuss that specific tax return and tax year with the IRS; and (4) **Oral Disclosure** - Authorizes the IRS to disclose the taxpayer's tax info to a person the taxpayer brings into a phone call or meeting with the IRS about a specific tax issue. And a taxpayer can choose to revoke any of these authorizations at any time.

☞**Education Related Tax Breaks**

There are a number of tax breaks available for education related expenses that should be kept in mind as we approach the 2023 tax return busy season.

Student Loan Interest: The deduction for student loan interest is "for AGI" (i.e., claimed on **Schedule 1**) so there is no need that the taxpayer itemize their deductions on **Schedule A**. Up to $2,500 of such interest can be claimed annually and this limit applies regardless of filing status (i.e., MFJ filers, however, only get the *same* $2,500 write-off as unmarried taxpayers). For the 2023 tax year, the deduction for student loan interest starts to phase out at $75,000 for unmarried taxpayers, and $155,000 for MFJ filers and ends at $90,000 and $185,000 of modified AGI, respectively.

Parents who might be helping their children pay off their loan balances are *not* entitled to this deduction unless they are also legally liable on the debt (e.g., as a co-signer or guarantor).

> **Comment:** An exception would exist where the parents paid off some of the loan balance (including any interest) and it is considered to be a deemed gift to their child. And if the child's AGI is below the phaseout threshold, they will be able to otherwise claim the interest paid as a deduction (up to the $2,500 limit). The other requirement, however, is that the child can longer be

taken as a dependent on the parents' tax return for the applicable tax year.

Cancellation of Student Debt: The majority of student loan debt forgiven in 2021 through 2025 is excludible from gross income for federal income tax purposes. This relief, which was part of the March 2021 stimulus law, is an exception to the general rule (i.e., under **Code §61(a)(11)** and **Code §108**) that COD income is taxable. The IRS has previously instructed lenders and loan servicers to *not* issue a **Form 1099-C** to borrowers whose student loans are forgiven during this time period. Nevertheless, some states have different rules, so the possible taxation of these forgiven amounts should be checked.

> **Comment:** Since a **Form 1099-C** will *not* be issued, there is no "paper trail" flowing to the IRS. Therefore, **Form 982** need *not* be filed to claim an exception to the normal COD income rules. In fact, **Part I** of **Form 982** does *not* even list any specific "exception" for this forgiveness of student loan debt.

Sec. 529 Accounts: Up to $10,000 of the earnings from Sec. 529 accounts can be used to help pay off any debt incurred for "qualified higher educational expenses" of the account beneficiary without any income tax due on the withdrawals. However, the $10,000 cap is a *lifetime* limit, *not* an annual limit. As a result, Sec. 529 distributions for student loan repayments that exceed $10,000 are taxable in part to the extent of the excess and are also subject to a 10% penalty.

Schedule 1 Reporting: The earnings portion of a taxable Sec. 529 plan distribution must be reported on the beneficiary's or the Sec. 529 plan account owner's tax returns. To calculate the taxable portion of the Sec. 529 plan distribution:

1. Divide the AQEE by the total 529 plan distribution (**Form 1099-Q, Box 1**)

2. Multiply the answer by the earnings portion (i.e., percentage) of the total distribution (**Form 1099-Q, Box 2**)

3. Subtract this amount from the total distributed earnings

The result must be reported as income on the beneficiary's or the account owner's federal income tax return, **Schedule 1 Form 1040, line 8**. If the distribution is also subject to the 10% penalty tax (i.e., because it was used for other than "qualified higher educational expenses"), the additional tax must be reported on **Schedule 2, Form 1040, line 6**.

> **Comment:** This $10,000 special provision for repayment on student loan balances outstanding is distinct from the *annual* $10,000 of Sec. 529 earnings which can be used for K-4 through grade 12 educational expenses.

Educational Assistance Programs: Employers that offer "qualified educational assistance programs" (i.e., pursuant to **Code §127**) can also help with their employee's educational costs. Up to $5,250 of an employee's college loans can be covered annually by the employer through 2025. Such payments are excluded from workers' wages for income and employment tax purposes.

> **Comment:** It is hard to believe that this $5,250 limit is the same amount used back in the mid-1980s when the cost per credit was much lower and has never been adjusted for inflation.

Employer Contributions to Retirement Plans: Beginning with the 2024 tax year, employers can offer assistance through their workplace retirement plans. This new **SECURE 2.0** change will allow employer 401(k) or 403(b) contribution matches to the extent of student loan repayments made by their employees. The employer contribution matches can occur regardless of whether the employees in question were also paying in to their retirement plan. Participation by the employer will be voluntary, but employees will have to elect to enroll in the program.

☞**Parents Helping to Repay Child's Student Loan**

It is becoming more common for parents to help their child deal with the repayment of their student loans. Nevertheless, parents are generally *not* allowed to take a deduction for the interest that they pay on this indebtedness unless they are also legally liable on the loan for repayment. Fortunately, the tax law views this assistance as a deemed gift from the parents to their child. As a result, the child may instead be entitled to the interest deduction. The child can claim the interest expense as a for-AGI deduction, as long as they can no longer be claimed as a dependent on the parents' return. And, the overall $2,500 annual cap applies, as well as phaseout rules (e.g., $70,000 to $85,000 of modified AGI for single taxpayers). **(Code §163; Student Loan Interest)**

> **Comment:** This type of analysis was also used in ***Judith Lang*, TC Memo 2010-286 (12/30/2010)** where a mother paid certain itemized deductions (e.g., mortgage interest and taxes or medical expenses) on behalf of her child. As is the case here, the Tax Court agreed that this should be treated as a deemed gift flowing from her to her child who then is given the benefit of the associated itemized deduction on **Schedule A**.

☞**IRS Introduces "Interactive Tool" for Taxpayers to Get Answers to Tax Questions (Tax Tip 2019-93)**

In a recent promotional piece, the Service stated that "tax questions can pop up any time of the year. When people need answers, they should start with **Interactive Tax Assistant**. It's a tool that provides answers to a many tax law questions."

> **Comment:** Perhaps a review of some of these tips by your newer tax staff member might be worthwhile, or they could be forwarded in response to some of your client inquiries as a time-saving measure.

The taxpayer is instructed to answer a series of questions and the tool gives then gives them a response based on those answers. Here are some of the topics covered:

Filing Requirement

- **Do I Need to File a Tax Return?**
- **Should I File an Amended Return?**

Filing Status, Dependents and Exemptions

- **Whom May I Claim as a Dependent?**
- **What Is My Filing Status?**
- **May I Claim an Exemption for Myself or My Spouse?**
- **How Much Can I Deduct for Each Exemption I Claim?**

Retirement: Pensions, IRAs, Social Security

- **Are My Social Security or Railroad Retirement Tier I Benefits Taxable?**

- **Is My Pension or Annuity Payment Taxable?**
- **Do I Need to Report the Transfer or Rollover of an IRA or Retirement Plan on My Tax Return?**
- **Is the Distribution from My Roth Account Taxable?**
- **Is the Distribution from My Traditional, SEP or SIMPLE IRA Taxable?**

Other Income

- **How Do I Claim My Gambling Winnings and/or Losses?**
- **Do I Have Income Subject to Self-Employment Tax?**
- **Is My Tip Income Taxable?**
- **Are Payments I Receive for Being Unemployed Taxable?**

Deductions

- **How Much Is My Standard Deduction?**
- **Can I Deduct My Medical and Dental Expenses?**
- **Can I Deduct My Mortgage-Related Expenses?**
- **Can I Deduct My Charitable Contributions?**
- **Can I Claim My Expenses as Miscellaneous Itemized Deductions on Schedule A (Form 1040)?**
- **Are My Work-Related Education Expenses Deductible?**

Credits

- **Am I Eligible to Claim an Education Credit?**
- **Does My Child/Dependent Qualify for the Child Tax Credit or the Credit for Other Dependents?**
- **Am I Eligible to Claim the Child and Dependent Care Credit?**
- **Do I Qualify for the Credit for the Elderly or Disabled?**
- **Do I Qualify for the Retirement Savings Contributions Credit?**

☞**Filing Requirements and Tax Issues for Expatriates**

The IRS is reminding U.S. citizens and resident aliens living abroad of their tax filing obligations. Regardless of where they live or actually earn their income, they have a responsibility to report all of their *worldwide* income (i.e., wages, unearned income and tips) for U.S. income tax purposes. In other words, they have the *same* income tax filing requirements as U.S. citizens or resident aliens living in the United States. In addition, this income tax filing requirement applies even if a taxpayer otherwise qualifies for tax benefits such as the Foreign Earned Income Exclusion (i.e., on **Form 2555**) or the Foreign Tax Credit (i.e., on **Form 1116**), which reduce or eliminate U.S. tax liability. But these tax benefits are available only if an eligible taxpayer files a U.S. income tax return.

Taxpayers *living outside* of the U.S. and Puerto Rico have an automatic extension to file (i.e., but *not* to pay) until June 15th of each year (i.e., instead of April 15th). This automatic two-month extension to June 15th applies if both their tax home and abode are outside the United States and Puerto Rico. Even with an extension, however, such taxpayers will still have to pay interest on any tax *not* paid by the normal April 15th due date.

Those individuals *serving in the military* outside the U.S. and Puerto Rico on the regular April 15th due date of their tax return also qualify for the extension to June 15th. Taxpayers should attach a statement to their tax return if either one of these two situations applies. More detailed information can be found in the **Instructions** for **Form 1040**, **IRS Pub. 54**, **Tax Guide for U.S. Citizens and Resident Aliens**

Abroad and **IRS Pub. 519, U.S. Tax Guide for Aliens**.
Reporting requirement for foreign accounts and assets.

> **Comment:** As discussed below, federal tax law also requires U.S. citizens and resident aliens to report their worldwide income, including income from foreign trusts and foreign bank and other financial accounts on **Form 8938**, as well as **FinCEN Form 114**.

Form 1040 Schedule B: - In most cases, affected taxpayers should attach **Schedule B** to their federal return to report foreign assets. **Part III** of **Schedule B** asks about the existence of foreign accounts such as bank and securities accounts and usually requires U.S. citizens and resident aliens to report the country in which each account is located. There is also a vital question which asks if the taxpayer has "signatory authority" over a foreign bank account.

Form 8938, Statement of Foreign Financial Assets: Some taxpayers may also need to attach **Form 8938** to their return to report specified foreign financial assets if the total value of those assets exceeds certain thresholds.

> **Comment:** For joint return filers, they would satisfy the reporting threshold only if the total value of their "specified foreign financial assets" is more than $400,000 on the last day of the tax year or more than $600,000 at any time during the tax year. Note that these thresholds are different than those applicable to *domestic* U.S. taxpayers (i.e., if the value of any foreign account exceeds $50,000 for unmarried individuals and $100,000 for joint filers at any point during the tax year).

FinCEN Form 114: Individuals must also report ownership of financial foreign assets (e.g., brokerage or bank accounts) if their value exceeded $10,000 or more at any point during the tax year to the Treasury Department on **FinCEN Form 114**.

> **Comment:** The deadline for filing the annual **Report of Foreign Bank and Financial Accounts (FBAR)** is April 15th, although U.S. persons who miss the April deadline have an *automatic* extension until Oct. 15th (, to file the FBAR.

Foreign Earned Income Exclusion: Under **Code §911**, individuals who meet either the "physical presence" test or the "bona fide residence" test are allowed to exclude up to a certain amount of their foreign earned income (i.e., $120,000 for 2023). These "tests" are claimed on **Form 2555** with the "physical presence" test requiring the taxpayer to be living out of the U.S. 330 days during a 365-day period (i.e., which can extend over two tax years). As an alternative, the taxpayer can claim that they have now become a "bona fide resident" of a foreign country (i.e., which does *not* require any specific minimum amount of days abroad, but just an intent to live outside of the U.S. for an indefinite period of time). **(Misc.; Foreign Income)**

> **Comment:** Reimbursements for foreign housing costs, within certain limits, can also be excluded from the taxpayer's gross income as well. Individuals working abroad will get a bit more relief on housing costs in 2023. The standard ceiling on the foreign housing exclusion increases to $16,800, up $1,120 from last year. But workers in many high-cost locations around the world qualify for a higher exclusion. IRS **Notice 2023-26** has more detailed information on this exclusion.

Code §24 - Child Tax Credit:

☞Claiming Credit for "Other Dependents"

Comment: With unmarried couples cohabitating, it is *not* unusual that the non-parent adult living in that household might be able to claim a tax credit for another unrelated individual, given the following requirements are met.

Taxpayers with dependents who fail to qualify for the child tax credit may still be able to claim the credit for "other dependents." Keep in mind, though, that this is a *non-refundable* credit. As a result, it can serve to otherwise reduce or, in some cases, eliminate a tax bill. But, the IRS cannot refund the taxpayer any portion of the credit that may be left over.

Here is some additional information which is intended to help taxpayers determine if they are eligible to claim it on their 2021 tax return. The maximum credit amount is $500 for each dependent who meets certain conditions. These include:

- Dependents who are age 17 or older (i.e., the other partner in the relationship)
- Dependents who have individual taxpayer identification numbers
- Dependent parents or other "qualifying relatives" supported by the taxpayer
- Dependents living with the taxpayer who are *not* related to the taxpayer

The credit begins to phase out when the taxpayer's income is more than $200,000 (for MFJ filers, the phaseout begins at $400,000). A taxpayer can claim this credit if:

- They can claim the person as a **dependent** on the taxpayer's return;
- They *cannot* otherwise use the dependent to claim the child tax credit or additional child tax credit; and
- The dependent is a U.S. citizen, national or resident alien

Taxpayers are permitted to claim the credit for "other dependents" in addition to the **child and dependent care credit** and the **earned income credit**. They can also use the **IRS Interactive Tax Assistant, Does My Child/Dependent Qualify for the Child Tax Credit or the Credit for Other Dependents?**, to help determine if they are eligible to claim the credit. **(Code §24; CTC)**

Code §61 - Gross Income:

☞**Properly Reporting Tip Income**

Workers in restaurants, salons, hotels and similar industries often receive gratuities for the customer service they provide. Normally, tips would be included in gross income, but it is also important for people working in these areas to understand the important reporting details involving tips.

Comment: The IRS recently came out with this guidance on tips and how they should be reported, especially in the case of an employee receiving them.

Tips Defined: Tips are optional cash or noncash payments that customers make to employees. This would include:

- Those received directly from customers, electronically paid tips distributed to the employee by their employer and tips received from other employees under any tip-sharing arrangement. Furthermore, all *cash* tips must be reported to the employer.

- *Noncash* tips are those of value received in any other medium than cash, such as: tickets, passes or other goods or commodities that a customer gives the employee. Noncash tips (e.g., pre-paid VISA gift cards) need *not* be reported to the employer.

Four factors determine whether a payment qualifies as a tip. Normally, *all* four must apply:

- The customer makes the payment free from compulsion;

- The customer must have the unrestricted right to determine the amount;

- The payment should *not* be the subject of negotiations or dictated by employer policy (such as a set "service charge" which is automatically included with the bill); and

- Generally, the customer has the right to determine who receives the payment.

Direct and Indirect Tips: A "direct tip" occurs when an employee receives it directly from a customer, even if it is part of a tip pool. Examples of directly-tipped employees include waiters, waitresses, bartenders and hairstylists. On the other hand, an "indirect tip" occurs when an employee, who normally does *not* receive tips directly from customers, receives a tip. Examples of indirectly-tipped employees include busboys, service bartenders, cooks and salon shampooers.

Keeping Daily Tip Records: Employees are required to keep a *daily* record of the *cash* tips they receive. They can use **Form 4070A, Employee's Daily Record of Tips**, which is included in **IRS Pub. 1244, Employee's Daily Record of Tips and Report of Tips to Employer**, to keep daily track of the *cash* tips they receive. They should also keep a record of the date and value of any *noncash* tips, such as tickets, passes or other items of value. Although they are *not* required to report *noncash* tips to their employer, they must report them on their tax return as additional gross income.

Tip Reporting to Employer: There is specific form required, but any such statement must include:

- Employee signature;

- Employee's name, address and social security number;

- Employer's name and address (establishment name if different);

- Month or period the report covers; and

- Total of tips received during the month or period.

Employees are required to report their tips to the employer by the 10th of the month following the month the tips were received. The employee can use **Form 4070, Employee's Report of Tips to Employer**, available in **IRS Pub. 1244**, an employer-provided form or other electronic system used by their employer as long as it includes the above elements required for reporting. Employees, however, do *not* have to report tip amounts of less than $20 per month per employer.

Reporting tips on Form 1040: Tips reported to the employer by the employee (i.e., as opposed to those received by an independent contractor) are included on the employee's **Form W-2, Wage and Tax Statement**, for reporting on an individual tax return. Any tips that the employee did *not* report to the employer must be reported *separately* on **Form 4137, Social Security and Medicare Tax on Unreported Tip Income**, to be included as additional wages with their tax return. The employee must also pay the employee share of Social Security and Medicare tax owed on those tips.

Tip Reporting for Employers: Employers with tipped employees are required to:

- Keep employee tip reports;

- Withhold taxes, including income taxes and the employee's share of Social Security tax and Medicare tax, based upon employee's wages and tip income;

- Pay the employer share of Social Security and Medicare taxes based on the total wages paid to tipped employees as well as the reported tip income;

- Report this information to the IRS on Form 941**, Employer's Quarterly Federal Tax Return**; and

- Deposit the withheld taxes in accordance with federal tax deposit requirements.

Additional IRS Guidance: More information on tip reporting requirements can be found at: (1) **Tip Recordkeeping & Reporting**; (2) **IRS Pub. 531, Reporting Tip Income**; (3) **IRS Pub. 1244, Employee's Daily Record of Tips and Report of Tips to Employer**; and (4) **IRS Pub. 15, Employer's Tax Guide**.

> **Comment:** The Service has released (**Ann. 2000-22**) a revised draft of its **Tip Reporting Alternative Commitment (TRAC)** agreement for the food and beverage industry. The revised agreement responds to employers' requests for more flexibility in the education program and tip **reporting procedures**. **(Code §61; Employee Tips)**

Code §108 - Cancellation of Indebtedness:

☞Tax Implications for "Short Sales" on Principal Residences

There is a separate rule for *recourse* loans (i.e., where the debtor is personally liable) for the shortfall on the sale. In those situations, if the lender ends up forgiving the remaining debt (i.e., for which the home owner will receive a **Form 1099-C** for amounts over $600), up to $750,000 of forgiven debt on a *primary* residence is still excludible from gross income. This is accomplished by filing **Form 982** and checking off this exception in **Part I** of the form.

On the other hand, the result differs in those situations involving a *nonrecourse* loan (i.e., where the debtor is *not* personally liable for the deficiency). In this case, the forgiven debt will have to be included in the "amount realized" for calculating gain or loss on the short sale. And, for a personal residence, no loss is allowed. But, up to $250,000 of the gain ($500,000 for MFJ filers) can be excluded from gross income (i.e., pursuant to **Code §121**). **(Code §108; Short Sales)**

> **Comment:** Mortgage interest paid on a *nonrecourse* loan in a short sale is deductible, as confirmed by a recent appeals court decision. It involved a situation where a couple who filed for bankruptcy got their home loan converted from *recourse* to *nonrecourse*. When the mortgage company later sold the residence in a "short sale," it credited a portion of the sales proceeds toward the unpaid interest on the secured home loan and sent the couple a **Form 1098**. The couple itemized and deducted the home mortgage interest on **Schedule A**. But, the IRS denied the deduction upon audit and got a lower court to agree with the Service's position. The appeals court, however, *reversed* the lower court's decision, stating that the "short sale rules" on the extinguishment of *nonrecourse* debt led to deductible mortgage interest here (***Milkovich*, No. 19-35582 (9th Cir., 3/2/2022)**)

☞Properly Calculating One's Level of "Insolvency" for COD Exception

Code §61(a)(12) clearly includes the forgiveness of debt as an item of gross income. However, **Code §108** provides a number of exceptions including insolvency which allow a taxpayer to avoid picking up this gross income otherwise reported on Form 1099-C. Nevertheless, the level of insolvency must be sufficient to cover the entire amount of the COD income (i.e., if a complete exclusion is to be claimed). And, in making this determination, IRS **Pub. 4681** makes it clear that in calculating insolvency, assets include everything you own, including "exempt assets which are beyond the reach of your creditors under the law, such as your interest in a pension plan and the value of your retirement account." As a result, it will be a great deal more difficult to claim this exception if one has to include assets owned through an IRA or a qualified retirement plan such as a 401(k) or a 403(b). **(Code §108; COD Income)**

Code §121 - Exclusion of Gain From Sale of Principal Residence:

☞Partial Exclusion Available for Gain on Sale of Principal Residence

Some sales of main homes are eligible for a *partial* exclusion of gain. This comes into play where the taxpayer otherwise has failed to meet the normal two-year use and residency tests (i.e., when looking at any of the 24 months, whether consecutive or not, during the 60-month period leading up to the actual date of the sale). The result is that the percentage of the $500,000 or $250,000 gain exclusion that can be taken is equal to the portion of the two-year period that the seller actually used the home as a principal residence. Some of the special circumstances that might come into play include a sale of the home that resulted in a job change, as well as an illness (e.g., elderly parent has to be moved into a nursing home) or "unforeseen circumstances" qualify (e.g., a divorce where the newly wed couple has only lived in their new home for less than 24 months). **(Code §121; Home Sale Exclusion)**

Example: "Calculation of Partial Sec. 121 Gain Exclusion"

A married couple purchased a home for $500,000 in August of 2020, lived in it for 19 months and sold it in February of 2022 for $750,000 due to the fact that one of the spouses had secured a new employment position that was located in a distant state. The maximum gain exclusion in this instance is $395,833 ($500,000 x (19/24)) which would be more than enough to cover the $250,000 gain. Note also that either actual days living in the home instead of months can be used for this calculation.

Comment: IRS Pub. 523 contains a good bit of detailed information regarding the sale of one's home.

☞Reduced Homesale Exclusion for Nonqualified Use Necessitates More Recordkeeping for Certain Sellers

The "Housing Assistance Tax Act of 2008" includes a couple of breaks for residential real estate; namely, a new tax credit for "first-time" homebuyers and a new property tax deduction for non-itemizing homeowners. It also contains a controversial new restriction on the **Code §121** exclusion. The restriction is intended primarily as a device to restrict or eliminate tax-free homesale profits for those who use the exclusion once on a principal residence sale and then convert a vacation home to principal residence use and sell the second home for another tax-free homesale profit (i.e., after waiting for the necessary 2-year period of use as a principal residence). However, because of the complex new restriction on "nonqualified use," it could cause significant headaches for those selling homes after 2008, including those situations where the taxpayer never owned more than one home.

Background: Under **Code §121(a)**, a taxpayer can exclude from income up to $250,000 of gain from the sale of a home owned and used by the taxpayer as a principal residence for at least 2 of the 5 years before the sale. The full exclusion does *not* apply if, within the 2-year period ending on the sale date, the exclusion was taken in regard to another home sale by the taxpayer. Married taxpayers filing jointly for the year of sale may exclude up to $500,000 of homesale gain if: (1) *either* spouse owned the home for at least 2 of the 5 years before the sale, (2) *both* spouses used the home as a principal residence for at least 2 of the 5 years before the sale, and (3) neither spouse is ineligible for the full exclusion because of having claimed it within the prior two years. Nevertheless, the homesale exclusion does *not* apply to gain attributable to post-May 6, '97, depreciation claimed for either rental or business use of a principal residence. Also, a reduced maximum exclusion may apply to taxpayers who sell their principal residence but: (1) fail to qualify for the 2-out-of-5-year ownership and use rule, or (2) previously sold another home within the two-year period ending on the sale date of the current home in a transaction to which the exclusion applied. But, if the taxpayer's failure to meet either rule occurs because he must sell the home due to a change of place of employment, health, or to the extent provided by regs, other unforeseen circumstances, then he may be entitled to a reduced maximum exclusion. Under these circumstances, the maximum gain that can be excluded is equal to the full $250,000 or $500,000 exclusion times a fraction. Its numerator is the *shorter* of (a) aggregate periods of ownership and use of the home by the taxpayer as a principal residence during the 5 years ending on the sale date, or (b) the period of time after the last sale to which the exclusion applied, and before the date of the current sale. The denominator is 2 years (or its equivalent in months).

Restriction Due to "Nonqualified Use:" For sales and exchanges *after* Dec. 31, 2008, the **Code §121(a)** rule excluding homesale gain will *not* apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of "nonqualified use." (**Code §121(b)(4)**) Generally, nonqualified use is any period (other than the portion of any period *before* Jan. 1, 2009) during which the property is *not* used as the principal residence of the taxpayer or spouse. For example, use of a residence as rental property or as a vacation home would be considered "nonqualified use" (subject to some exceptions discussed below).

> **Comment:** It should be noted that it is *not* the otherwise allowable exclusion that is reduced for nonqualified use. Instead, it is the actual gain potentially eligible for the exclusion. As a result, if the homesale gain is otherwise large enough, the seller may be able to use the full homesale exclusion despite extensive periods of nonqualified use.

Example: A single taxpayer buys a residence *after* 2008, uses it as a vacation home for four years, and then uses it as a principal residence for four years. If he then sells the home and a realizes a gain of $500,000, half of the gain will be allocable to nonqualifying use and subject to tax as long-term capital gain, but the other half will qualify for the full $250,000 homesale exclusion.

How to Allocate to Nonqualified Use: For determining the amount of gain that is allocated to periods of "nonqualified use," gain will be allocated to periods of nonqualified use based on the ratio which:

- the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, bears to;

- the total period that the property was owned by the taxpayer. (**Code §121(b)(4)(B)**)

According to the technical language contained in the Committee Reports, gain allocated to periods of "nonqualified use" is the total amount of gain multiplied by a fraction: (1) the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, and (2) the denominator of which is the period the taxpayer owned the property.

Example: Mary, a single taxpayer, bought a home on Jan. 1, 2009, for $400,000, and uses it as rental property for two years claiming $20,000 of depreciation deductions (thereby reducing his basis in the home to $380,000). On Jan. 1, 2011, she converts the property to her principal residence. On Jan. 1, 2013, Mary moves out of the home and sells it for $700,000 on Jan. 1, 2014, and thus has a gain of $320,000 ($700,000 - $380,000). Under pre-Act law, Mary would have had $20,000 of gain attributable to depreciation deductions included in income (taxed at 25% as "unrecaptured section 1250 gain"), and would have excluded $250,000 of his gain (because she had two full years of ownership). The $50,000 balance of her long-term gain would have been taxed at a maximum rate of 15%. Under change made by the Housing Act, the *same* $20,000 of gain attributable to Mary's depreciation deductions is still included in income (i.e., taxed at 25% as "unrecaptured Sec. 1250 gain). Then, of the remaining $300,000 gain, 40% (2 years ÷ 5 years), or $120,000, is allocated to "nonqualified use" and is *not* eligible for the exclusion (and is taxed at maximum rate of 15%). The remaining gain of $180,000 is excluded under **Code §121**, since it is less than the maximum excludible gain of $250,000. As a result, the new law change costs Mary $10,500 (.15 × $70,000).

Comment: Presumably, the fraction will be expressed in *either* days or months in the same manner as the fraction that applies for determining the amount of the reduced exclusion for certain taxpayers failing to meet the ownership and use requirements or for taxpayers who have sold or exchanged principal residences within two years.

Comment: It is important to remember that a period of "nonqualified use" (as used in the numerator in the fraction above) will *not* include any period *before* Jan. 1, 2009. But, the denominator (i.e., the period that the taxpayer has owned the property) will include periods of ownership *before* Jan. 1, 2009. Thus, at least the law will *not* have a retroactive impact. But, clients will should either sell such properties *before* 1/1/2009, or at least consider the impact of these changes to any property that they may be considering converting and then selling *after* 2008.

Definition of "nonqualified use:" Generally, nonqualified use is any period (other than the portion of any period *before* Jan. 1, 2009) during which the property is *not* used as the *principal* residence of the taxpayer or spouse.

Comment: After buying an existing residence, a taxpayer may take an extended period of time to remodel, improve and/or enlarge it before he actually moves into the home and begins to use it as a principal residence. During that remodeling period, some commentators have expressed the concern that the taxpayer would *not* be considered to be using the residence as his principal residence. As a result, an argument could be made that the remodeling period could be construed to be a period of "nonqualified use" under **Code §121(b)(4)(C)(i)**. Certainly, it is issues such as this one which should be addressed by the IRS in future guidance.

Comment: Under **Reg. §1.121-1(b)**, another issue that might arise is whether a property is actually being used as a "principal residence" based on the underlying facts and circumstances. For instance, if a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's "principal residence." Nevertheless, this "majority of the time test" is *not* dispositive if other relevant factors indicate that another residence is the taxpayer's principal residence.

"Nonqualified use" does *not* include use that falls into one of the following three categories:

(1) Post-principal-residence use: "Nonqualified use" does *not* include any portion of the **Code §121(a)** 5-year period which is *after* the last date that the property is used as the principal residence of the taxpayer or spouse. (**Code §121(b)(4)(C)(ii)**)

Example: Marc buys a principal residence on Jan. 1, 2009 and moves out on Jan. 1, 2019. On Dec. 1, 2021, he sells the property and realizes a $200,000 gain, *all* of which will be excluded from gross income. The property's use following Marc's departure from the property (e.g., as rental or vacation property, or vacant and held for sale) will *not* affect the otherwise allowable exclusion amount.

> **Comment:** The bottom line is that, in order to qualify for the full homesale exclusion under the **Code §121(a)** two-out-of-five year ownership and use rule, the nonqualifying use *after* the owner leaves his principal residence is still *not* allowed to exceed three years (i.e., 36 months, or the 2/5 test would never be satisfied). Instead, the new law is focused upon properties that are converted after 2008 to principal residences *after* being used for some other purpose such as rental or vacation property.

(2) Qualified official duty exception: Nonqualified use does *not* include any period (not to exceed an aggregate period of 10 years) during which the taxpayer or spouse is serving on "qualified official extended duty." (**Code §121(b)(4)(C)(ii)**) Qualified official extended duty means duty as a member of the uniformed services or the Foreign Service, or as an employee of the intelligence community. (**Code §121(b)(4)(C)(ii)(II)**)

Example: Ellen buys a house in Virginia in Year 3 (a year beginning *after* Dec. 31, 2008) that she uses as her principal residence for three years. For eight years, from Year 6 through Year 14, Ellen serves on qualified official extended duty as a member of the Foreign Service in Germany. In Year 15, Ellen sells the Virginia house. She elected to suspend the ownership and use five-year testing period for the **Code §121** exclusion during her eight-year period of service in Germany (i.e., qualified official extended duty). As a result, the eight-year period is *not* counted in determining whether Ellen used the house for two of the five years preceding the sale for purposes of the homesale exclusion (including the amount of gain allocated to periods of nonqualified use).

(3) Temporary absence exception: A period of nonqualified use will *not* include any other period of "temporary absence" (defined as a period not to exceed an aggregate of two years) due to change of employment, health conditions, or any other unforeseen circumstances as may be specified by the IRS. (**Code §121(b)(4)(C)(ii)(III)**)

Example: On Jan. 1, Year 2 (a year beginning after Dec. 31, 2008), Rhonda, a resident of New York, buys a house in Minnesota that she intends to use as her principal residence. Before she can move into the Minnesota house, Rhonda is seriously injured in an accident on Feb. 1, Year 2 and is unable to move to Minnesota until Jan. 1, Year 4. For the next three years (until Dec. 31, Year 7), she lives in the Minnesota house. On Jan. 1, Year 7, Rhonda sells the Minnesota house. Presumably, Rhonda's absence from the Minnesota house will qualify for the temporary absence exception because the absence did *not* exceed an aggregate period of two years and was due to a change in health conditions (and also might have been due to "unforeseen circumstances").

> **Comment:** In this instance, the language of the temporary absence exception is similar to the circumstances described in **Code §121(c)(2)(B)** that qualify for the reduced maximum exclusion (i.e., conditions stemming from a change in place of employment, health, or, to the extent provided in regs, unforeseen circumstances).

Coordination With Recognition of Gain Attributable to Depreciation: For determining the amount of gain allocated to nonqualified use of a principal residence, the following rules apply:

- the rule providing that gain allocated to periods of nonqualified use does *not* qualify for the exclusion is applied *after* the application of **Code §121(d)(6)** (i.e., rules providing that gain attributable to post-May 6, '97 depreciation does *not* qualify for the exclusion), and

- the rules providing for the allocation of gain to periods of nonqualified use are applied without regard to any gain to which **Code §121(d)(6)** applies. (**Code §121(b)(4)(D)**) **(Code §121; Home Sale Exclusion)**

> **Comment:** See the first example above where Mary sold her home for a $320,000 gain, of which $20,000 was "unrecaptured Sec. 1250 gain," and then the remaining $300,000 gain had to be prorated based on the fact that she had rented out her home for 2 years *before* using it as her principal residence for the next 3 years.

Code §162 - Trade or Business Expenses:

☞**"12-Month Rule" to Garner Additional Tax Deductions**

Expense items paid for in advance are normally deductible only in the specific tax year to which they apply. One exception, however, might be where the "12-month rule" otherwise comes into play. It is a rule that can be used for *both* accrual and cash basis taxpayers, although the latter really benefit most from it. Under this exception outlined in **Reg. §1.263(a)-4(f)** taxpayers are *not* required to capitalized such expenditures "paid to create certain rights or benefits" on the taxpayer's behalf that do *not* extend beyond the *earlier* of: (1) 12 months after the right or benefit begins or (2) The end of the tax year after the tax year in which payment is made.

In situations where the taxpayer is "looking for additional deductions" to offset increases in overall income for a particular tax year, consideration should be given to paying the following types of expenses in advance:

- Utilities (e.g., heat, water, sewer, electricity, gas)

- Internet (e.g., cable, fiber, phone)

- Cell phone usage

- Rent (but if related party is involved, deduction only allowed if that related party simultaneously includes in income)

- Accounting, legal and other professional fees

- Office supplies

- Advertising and marketing costs

- Dues and licenses

- Continuing education related to taxpayer's business or trade

- Equipment lease payments

- Insurance (but limits might apply in certain situations)

Comment: If needed, these deductions can be taken advantage of on a continuing annual basis. But keep in mind that prepaid interest payments would *not* be allowed under this "12-month rule."

Code §163(h) - Qualified Second Residence:

☞$1 Million Grandfather Cap on Mortgage Interest & Refinancing

Under the TCJA, new mortgages (i.e., taken out *after* December 15, 2017) would be capped at $750,000 for purposes of the home mortgage interest deduction and would be allowed on *both* a principal residence, as well as a QSR (i.e., "qualified second residence" which would continue to include certain RVs and boats).

Comment: Some tax professionals have suggested that for clients with the available cash, you might want to consider paying down a higher mortgage balance (above either the $1 million, or new $750,000, cap), given there is no tax benefit for interest paid. But, if excess cash is *not* available, then it has been suggested that the client borrow against their investment assets. Nevertheless, such investment interest expense would *not* be deductible on **Form 4952** (i.e., as opposed to nondeductible mortgage interest), even if the taxpayer itemizes their deductions, since under the "tracing rules," the use of the funds was *not* to purchase investment assets, but rather to pay down a mortgage. The same result would occur if the borrowing was done against business assets, and then using otherwise available cash to pay down a mortgage (or, simply take a distribution of cash out of a K-1 business against available basis that the owner has in their S corp stock or partnership interest). Again, it is the "source" of the funds (i.e., the collateral being used to secure the loan), but instead the "use" to which the funds are put.

For any interest on mortgages taken out *before* December 16, 2017 to "build, buy or substantially improve a first or second home" (i.e., "acquisition indebtedness"), the limit will remain at $1,000,000 and would continue to be available for *both* the principal residence, as well as a "qualified second residence."

Example: "Grandfathered Mortgages in Excess of $1 Million Cap"
Taxpayer has a "grandfathered" mortgage of $1.5 million (when the cap for pre-12/16/17 mortgages is $1 million). He incurs interest expense of $60,000 for 2020. His mortgage interest deduction would be $40,000 (i.e., $1.0 million/$1.5 million x $60,000).

Refinancing Existing Mortgages: With regard to the refinancing of a mortgage, the $1 million/$500,000 limitations continue to apply to taxpayers who refinance existing qualified residence indebtedness that was incurred *before* Dec. 16, 2017, so long as the indebtedness resulting from the refinancing does *not* exceed the amount of the outstanding mortgage principal that existed beforehand.

Comment: However, if additional monies are taken out upon refinancing (i.e., the pre-12/16/17 outstanding balance increases at all), then the "grandfathered" exception is lost, at least as to these *additional monies* received (with any interest expense thereon, even if used to make improvements to the home, becoming nondeductible). This assumes that the original mortgage balance was $750,000, or more at the time of the refinancing.

Example: "Refinancing When Mortgage in Excess of Limitation"

A taxpayer had an $850,000 outstanding mortgage balance relating to the purchase of either a principal or qualified second residence as of 12/15/17. With the prospect of mortgage interest rates coming down, the taxpayer refinances this mortgage, but also receives an additional $50,000 to carry out home repairs or a remodeling project. As to the receipt of additional funds upon refinancing, the "grandfathered" exception (i.e., $1 million cap) is lost and the taxpayer would now be subject to the "new" (i.e., post-12-15-17) $750,000 cap (at least as far as the additional $50,000 received). As a result, the mortgage interest paid on this additional $50,000 borrowed (even if used to make "substantial home improvements") becomes *nondeductible*. The mortgage interest, however, on the original $850,000 balance outstanding as of the time of the refinancing would still fall under the "grandfather cap" of $1 million (and, therefore, would remain deductible).

Comment: If this refinancing occurred at a time that, for example, only a $700,000 outstanding balance remained on the mortgage, then even without the "grandfather cap" the new balance would still fall within the $750,000 limit (with all of the interest on this "qualified acquisition indebtedness" being deductible).

Comment: If the taxpayer in the example above discloses that 20% of his home is used for a business office (e.g., to conduct his partnership activities, or Schedule C or F proprietorship), then at least part of the allocated interest expense incurred after the 7/1/18 refinancing could be "taken above the line" (i.e., for purposes of determining AGI) on either Schedule E, page 2 (i.e., against any K-1 income from the partnership), or on Schedule C or F. In other words, it would *not* all be treated as nondeductible "consumer interest" (i.e., with regard to the additional $50,000 received). But, if the home office was used for employee-related activities (e.g., the employee/owner of an S corporation conducted his business out of this home office), then with the elimination of **Form 2106, Unreimbursed Employee Expenses** and 2% miscellaneous deductions, this would also be treated as *nondeductible*. But, the limitation under **Code §280A(c)(6)** would come into play anyway which denies deductions for home offices rented by an employee to an employer.

But, there is no question that the $100,000 "qualified equity indebtedness" exception has been eliminated. As a result, all interest would have to be "traced" to the use to which it was put (*same* rules as we currently have for AMT with "qualified housing interest" (QHI)).

☞Does It Matter Where Qualified Second Residence Is Located for Mortgage Interest Deduction?

Sometimes a client's vacation or second home is located outside of the U.S. Does it's location matter for purposes of taking a deduction for any mortgage interest paid? Looking at **Code §163(h)** regarding "qualified residence interest," you'll find that there is no mention of this as a prerequisite so long as the other tests are met (e.g., the combined mortgage total for their principal and second residences does *not* exceed $1 million (or, $750,000) and the debt is secured by a lien on the home). **(Code §163(h); QRI)**

Comment: When doing this research you will also find that for the definition of a "qualified residence" when seeking to take the $250,000/500,000 exclusion on the sale of a "principal" residence, it does *not* matter if the taxpayer's home is located outside of the U.S. (**Code §121**)

☞Taxpayers Can Have Only One Qualified Second Residence

Code §163(h) states that only one "qualified second residence" along with the interest on the taxpayer's principal residence can be deducted in any tax year. This issue comes up at times when the taxpayer has fully paid the mortgage on their principal residence but still owns two or more second qualified residences (and, they want to take a mortgage interest deduction for up to $1 million on the principal balances with regard to these homes; and, possibly the interest on a $100,000 equity line). **(Code §163(h); QSRs)**

Comment: This issue can also arise where older couples who each own a principal residence decide to get married and move into a new principal residence *before* at least one of the former residences is sold.

Code §170 - Charitable Contributions:

☞Ensuring Legitimacy of Charitable Donation Deductions

Taxpayers need to make sure that their donations go to legitimate charities. Especially when disaster strikes, American taxpayers can normally be counted upon to help the victims of a natural disaster. And the easiest way to help is by donating money to charities.

Unfortunately, criminals are just as likely to answer the call after a disaster or emergency as would the millions of people who open their wallets. Scammers solicit donations to fake charities and can pose as employees of legitimate charities or federal agencies to dupe disaster victims trying to get disaster relief. Furthermore, although some legitimate charities do contact people out of the blue, individuals should always be suspicious of unsolicited contact.
For instance, taxpayers donating money should keep a few things in mind:

- The IRS suggests that the **IRS Tax Exempt Organization Search** tool should be used to find or verify qualified charities. Only substantiated donations to these real charities will be tax deductible.

- Research a charity before sending a donation to confirm that the charity is real and to know whether the donation is tax deductible.

- Always get a receipt and keep a record of the donation.

- Review bank and credit card statements closely to make sure donation amounts are accurate.

With regard to potential scammers,' keep some of their strategies in mind:

- Legitimate charities do *not* ask for gift cards, cash, or wire transfers.

- Scammers may claim to work for the IRS or another government agency.

- Thieves may pose as a representative of a legitimate charity to ask for money or private information from well-intentioned taxpayers.

- Scammers can change their caller ID to make it appear they are a legitimate organization calling from a legitimate phone number.

- Scammers make vague and sentimental claims but give no specifics about how your donation will be used.

- Scammers set up bogus websites using names that sound like real charities.

- Bogus organizations often claim a donation is tax deductible when it is not.

Warning for Disaster Victims: Disaster victims can call the IRS disaster assistance line at 866-562-5227. IRS representatives will answer questions about tax relief or disaster-related tax issues.

Event though donating to a charity is a very effective way to help others after a disaster or emergency. But if taxpayers suspect a scam or fraud, they can report it to the Federal Trade Commission. **(Code §170; Charitable Contributions)**

> **Comment:** For more Information, the following sources are available: (1) **National Center for Disaster Fraud**; (2) **DisasterAssistance.gov**; and (3) **IRS Pub. 3067, IRS Disaster Assistance - Federally Declared Disaster Area**.

☞Charitable Donation of Vacation Home Yields No Deduction

Donation to a charity of the right to use your vacation home might *not* result in the charitable contribution that you initiated expected. Charities such as schools and churches oftentimes use such places as door prizes for dinners, galas or auctions that they sponsor to raise funds for their activities. Nevertheless, you still fail to get a charitable write-off because only a "partial interest" in the property was given. Furthermore, there is no corresponding deduction for the winning bidder, unless the charity received more from the person than the place is worth when awarding use of the home. If that wasn't enough, be wary of a little known tax trap if you also rent out the vacation property during the year. Namely, the time used by the winning bidder counts as personal use by you for purposes of the **Code §280A** "vacation home" rule that prohibits the deduction of rental losses when the owner's personal use tops the greater of 14 days or 10% of days rented at FMV. **(Code §170; Vacation Homes)**

Code §213 - Qualified Medical Expenses:

☞ Deduction for Cost of Special Education

The costs of special education can sometimes qualify as medical expenses which can be taken as an itemized deduction on Schedule A. This would include the cost of tuition, meals and lodging for schools that furnish special education to help children overcome learning disabilities caused by mental or physical impairments. The key to this deduction, however, is that any ordinary education received "must only be incidental to the special education." Costs paid for private tutoring by specially trained teachers also qualify as a medical deduction. Generally speaking, though, you will need to have a doctor's recommendation before taking the write-off for tax purposes. **(Code §213; Special Education)**

☞Cost of Health/Wellness Coaching as Deductible Medical Expense?

The question sometimes arises as to the cost of health and wellness coaching possibly qualifying as a deductible medical expense. The answer is that "it depends" based on the specific facts and circumstances."

Generally speaking, to qualify as a medical deduction (i.e., pursuant to **Code §213**), the expense must be incurred "primarily to alleviate or prevent a physical or mental disability or illness." According to IRS guidance in **Pub. 502**, taxpayers "should use objective factors" in determining whether an expense that is typically personal in nature, such as health and wellness coaching, is actually incurred for medical care. Among the various factors that the IRS states should be considered are as follows: (1) Whether the cost of the coaching is for diagnosing, treating, mitigating, preventing or alleviating the taxpayer's disease, as opposed to being merely beneficial to one's general health; (2) Whether the cost would *not* have been incurred but for the taxpayer's medical condition; and (3) Whether there is a doctor's recommendation and overview as to the effectiveness of the coaching. **(Code §213; Medical Expenses)**

☞Deducting Costs of Assisted Living Facility

According to the federal Health Insurance Portability and Accountability Act (i.e., HIPPA), beginning in 1997, the *entire* cost (including rent, food and services) related to community living may be deductible, but only if certain conditions (i.e., inability to perform "Activities of Daily Living"), as discussed below, are satisfied.

Assisted Living residents seeking tax deductions for the costs incurred and services received must qualify as "chronically ill." This definition refers to seniors who are unable to perform *two or more* "Activities of Daily Living" (ADLs: eating, transferring, bathing, dressing and continence) without assistance, or who need constant supervision because of a "severe cognitive impairment" such as Alzheimer's disease or related dementias. Furthermore, the Assisted Living resident must have been certified within the previous 12 months as "chronically ill" by a licensed health care practitioner.

In order to qualify for a deduction, personal care services must be provided "pursuant to a plan of care prescribed by a licensed health care practitioner." Many Assisted Living communities have on staff a licensed nurse or social worker who prepares a plan of care, sometimes called a "Wellness Care Plan," in coordination with the resident's physician which outlines the specific daily services the resident will receive in the community.

A key requirement underlying a possible tax deduction for such costs is that the taxpayer must be able to itemized their deductions on Schedule A. In addition, long-term care services and other unreimbursed medical expenses must exceed 7.5% of the taxpayer's adjusted gross income (assuming that the taxpayer is 65 or older, although the total must exceed 10% of AGI for AMT purposes).

> **Comment:** Generally, a taxpayer can deduct the medical care expenses of his or her parent if the taxpayer provides more than 50% of the parent's support costs. If several siblings, for instance, are together providing over 50% of such costs, they should have in place a "multiple support agreement" which will allow one of them to possibly claim the elderly parent as a dependent, even though the parent does *not* actually live with them. But, the tests required in general for claiming a dependent must still be met. And, the one that normally prevents the claiming of a dependent who does *not* reside with the taxpayer is that they cannot have gross income above the personal exemption amount (i.e., for 2015, $4,000).

If the taxpayer is able to perform four or more "Activities of Daily Living" (eating, transferring, bathing, dressing and continence) without assistance so that they would *not* be able to claim the entire cost of the assisted living facility, they might at least qualify to deduct those costs directly related to actual medical care. Normally, the facility provides a letter to its residents outlining the exact percentage of such costs.

> **Example:** Jack is 99 years old and lives in an assisted living care facility. The total rent that he paid for the current tax year was $43,500. Even though he has neuropathy in his legs (i.e., extreme numbness and pain), he is able to use a walker to get around. He is not able to prepare his own meals, but the facility provides 3 meals/day, More importantly, he is able to cut and eat his food without any additional assistance. He does bathe twice each week sitting in a shower chair and using a handheld showerhead. At times, he does wear "Depends," but he is able to use the bathroom without assistance. Although his choice of fashion is not cutting edge, he is able to dress himself each morning. And, as far as cognitive skills, although his eyesight is going bad, especially in his left eye due to glaucoma and macular degeneration, he still manages to read two newspapers each day, along with numerous periodicals that he subscribes to and 4 library books every two weeks. There is, however, some peace of mind living at the facility since he is provided an "emergency wrist monitor" which he can use to summon help should he fall, or otherwise need immediate assistance. Moreover, having a circle of friends and regular outings with the group certainly beats being alone in an independent living apartment located apart from the community center where he is now located. The assisted living facility provides him a letter at the end of the

year which states that 10% of his rent costs qualify as "nursing or medical care." But, the bottom line is that he has *not* been certified within the previous 12 months as "chronically ill" by a licensed health care practitioner.

As far as other qualified medical costs besides the rent paid to the assisted living facility, he incurs the following expenses for 2015: (1) Doctors, dentists and other medical specialists: $700; (2) Medical insurance premiums (Medicare and supplemental insurance) = $4,200; (3) Prescriptions = $1,200; and (4) Transportation = $200, for a total of $6,300. And, 10% (i.e., the allocation provided by his assisted living facility) x $43,500 = $4,350 was the portion of his rent qualifying as a medical expense. With an AGI of $35,000, his deductible medical expenses on Schedule A would be $7,150 ($10,650 - 3,500).

He was not able to give anything to charity for 2015, and his only other itemized deduction was $500 for sales tax (i.e., taken from the IRS table in lieu of state income tax). So, his total itemized deductions were $7,650 which did *not* exceed his $7,850 standard deduction (i.e., for 2015, $6,300 + $1,550 for age 65 and over).

Comment: Had Jack been unable to perform 2 or more of the ADLs listed above, and he had been certified within the previous 12 months as "chronically ill" by a licensed health care practitioner, his itemized deduction for medical costs would have been dramatically increase by the *entire* amount of $43,500 in rent paid to the assisted living facility which, in turn, would have enabled him to itemized his deductions for tax purposes v. taking the standard deduction.

Example: Ted has developed Alzheimers, but his wife Audrey is determined to keep both in their home of 45 years. It will be difficult, though, as Ted cannot get out of bed on his own, nor can he dress himself. He is also incontinent and needs some help to feed himself. The home health aides bath him twice each week and a lift is used each day to hoist him out of bed and transport him into the living room where he spends his day in a LazyBoy chair in front of the TV. Reading his newspaper is not possible anymore and he has trouble remembering his family members. More importantly, he is in "hospice care" and has been certified within the prior 12 months as being "chronically ill" by a licensed health care practitioner.

Whether you look at the "Activities of Daily Living" (ADLs), or his cognitive well-being, all of the costs related to keeping him in his home and assist in his daily activities (e.g., the cost of the home care aides coming in twice each day), or his otherwise qualified medical expenses ($23,500 in this case) such as health insurance premiums, doctors, prescriptions, etc. would be deductible on Schedule A. And, along with the real estate taxes ($3,500) the couple paid on their residence (no mortgage interest, though, since the house is paid off) and $500 in deemed sales tax paid (taken from the IRS tables v. state or local income taxes), they will itemized their deductions of $27,500 ($23,500 + $3,500 + $500) instead of taking the standard deduction of $15,000 (i.e., $12,600 + $2,400).

Comment: If Ted was in a nursing home with the same physical limitations, all of those costs would be fully deductible as well.

Comment: Detailed summaries concerning **"The Tax Deductibility of Long-Term Care Services & Assisted Living"** prepared by national accounting firms can be found on-line. Detailed information is also available in: (1) **IRS Pub. 502** **"Medical and Dental Expenses"** and (2) **IRS Pub. 501** **"Exemptions, Standard Deductions and Filing Information"** to learn more about claiming a person with dementia as a dependent. **(Code §213; Medical Deductions)**

Code §280A - Vacation Home Rentals:

☞**Handling Vacation Home Rentals**

The IRS has provided tips on renting a vacation home, which can be a house, cabin, apartment, condominium, mobile home, or boat. Rental income is reported on **Schedule E (Supplemental Income and Loss)**, unless the property also is used personally and rented out for less than 15 days per year. But, any net rental income may be subject to the new 3.8% Medicare on "net investment income" that applies beginning in 2013. A net loss on the rental activity is generally subject to passive loss limitations under **Code §469**. If the property is used personally for part of the time, the expenses must be allocated between the rental and personal use, based on the number of days actually used for each purpose. Any deductible expenses for personal use, such as mortgage interest and property taxes, are reported on **Schedule A (Itemized Deductions)**. If the property is used as a personal residence for part of the time (i.e., greater than 14/year, or 10% of the days rented at FMV), the renal expense deduction is limited to the rental income received. But, the excess deductions can be carried over to a future tax year where there is adequate rental income to offset them. Otherwise, these deductions would have to be carried over and deducted when the home is eventually sold (even if there is no gain reported on the sale).

Dealing With "Nonqualified Use:" Some practitioners seem to forget this change in the law regarding principal residences which is effective starting 1/1/2009. Specifically, **Code §121** states that the portion of any gain allocable to periods of "nonqualified use" are *not* allowed to be excluded under the normal $250,000/500,000 provisions. "Nonqualified use" includes any period of time that the property is *not* used as a principal residence. This would include when it might be sitting empty, or held for use as a rental or vacation/second home.

Example: Marc purchased an investment property in 2017 and proceeded to use it as a rental for 2017 and 2018. Then, upon retirement in 2018, he sold his principal residence and correctly offset any gain with the $500,000 exclusion provided for under **Code §121** and moved into his rental property. He then used it as his principal residence for 2018 and 2019. The home was then put up for sale and sold at the beginning of 2020 for a $100,000 gain.

Since there were two years of "nonqualified use" (i.e., 2017 and 2018) out of the four years that he own the property, only 50% of the gain is excludible under **Code §121**. The other $50,000 of gain (i.e., attributable to the use of the property as a rental) would be reported on **Form 4797**, with a part of this gain, to the extent of the straight-line depreciation taken, being taxed as "unrecaptured Sec. 1250 gain" at a 25% rate. The entire gain would then flow to the Schedule worksheet (i.e., **Form 8949**) where it could be used to offset any current or carryover capital losses.

Comment: If the property was used in more than one activity during the 12-month period ending on the date of disposition, proceeds and basis are generally allocated among the activities based on usage during that 12-month period (Cf. **Reg. §1.469-2T(d)(5)**). Here, though, the property was used for a nonpassive purpose (i.e., personal use) for the entire 12-month period leading up to the date of sale in early 2020. Nevertheless, it could be argued that this gain attributable to the period of "nonqualified use" (i.e., during 2017 and 2018 as a rental) is passive income and could therefore be offset by any current or suspended losses (i.e., on **Form 8582**).

Comment: For more information on tax issues involving rentals of vacation homes, go to the IRS **website**, and click on "**Tax Tips**."

Code §469 - Passive Activity Losses:

Note: The following excerpt was taken from the 2022 Passive Loss Guide.

☞**Excluded Gain on Sale of Former Residence Not Offset by Suspended Passive Losses (CCA 201428008)**

A taxpayer bought a principal residence and used it as his principal residence for two years before converting it into a rental property. During the three years the house was rented, the taxpayer reported $30,000 in rental net losses, which were suspended as passive losses under **Code §469(a)**. Within three years of renting the house (i.e., so as *not* to violate the 2-out-of-5-year rule for personal use), the taxpayer sold the property to an unrelated third party, realizing a net gain on the sale of $100,000 (without considering the $30,000 suspended passive losses). He then excluded the full $100,000 gain on sale under **Code §121(a)** (i.e., which provides for a maximum $250,000/500,000 gain exclusion on the sale or exchange of a "principal residence"). The IRS determined that under the facts of this case, because the $100,000 of gain realized was recognized upon the sale of the taxpayer's *entire* interest in a passive activity to an unrelated party, the **Code §469(g)(1)(A)** "disposition rule" applied. As a result, to the extent that the suspended passive activity losses exceeded any net income or gain for the tax year of the disposition from all other passive activities, the $30,000 losses would be treated as *not* being from a passive activity under **Code §469(g)(1)(A)**. Furthermore, because the $100,000 gain on the sale of the residence was excluded from the taxpayer's gross income under **Code §121**, it was *not* an item of passive activity gross income for purposes of **Code §469**. Therefore, the excluded gain from the sale did *not* result in any offset against the $30,000 suspended passive activity losses from the property. **(Code §469; PAL Disposition Rule)**

> **Comment:** This is a good result for the taxpayer since such losses will then still be available against other sources of taxable passive and nonpassive income (and, *not* be wasted against a gain that is already excluded).
>
> **Comment:** Understand that there is no question that, as of the time of the sale of this property, it was a rental activity. So, any gain or loss would still be reported on **Form 4797**. And, had there been a loss, it would have been treated as a nonpassive Sec. 1231 ordinary loss and carried over to page one of the taxpayer's **Form 1040**. Also, the $30,000 of suspended passive losses on **Form 8582** would also have been freed up to offset, first, any other passive income sources and, then, any other "active" or "portfolio" income. But, since there was a gain on the sale (i.e., $100,000) which would have been treated as Sec. 1231 gain had the **Code §121** principal residence exclusion *not* been available, the $30,000 of suspended loss is simply available to offset other passive income, if any, and then, other "active" or "portfolio" income. Either way, this qualified as a "complete disposition" under the passive loss rules and the $30,000 of suspended losses would have been freed up regardless of any gain or loss on the underlying sale of the residence.
>
> **Comment:** Any post-5/6/97 depreciation taken while this former principal residence was rented would result in "unrecaptured Sec. 1250 gain" which, in turn, would be a source of passive income which would first be offset the suspended rental losses.

☞**Sale of Former Passive Rental Activity Now Qualifying as a Principal Residence**

It is not an unusual fact pattern where a couple invests in a second home (e.g., condo) to which they intend to eventually retire. But, in the meantime, they may rent it out either on a part- or full-time basis in order to generate some cash flow to service the mortgage and taxes. Assume that the couple does in fact finally sell their principal residence, taking the **Code §121** exclusion on the resulting gain, and moves into this retirement home. Then, after living in this condo unit for a few years, they decide to purchase a stand-alone single-family residence. This condo, having been rented for a number of years before the conversion into a retirement home, is treated as a "former passive activity." And, when eventually sold, there will be several distinct issues that need to be addressed. Namely, there has been a period of "nonqualified use" (i.e., which is anything other than a "principal residence" *after* 2008), along with the fact that depreciation has been taken *after* 5/6/97 (i.e., with regard to the time period that it was rented). In addition, there might be some suspended passive rental losses still listed on **Form 8582**.

Example: A couple purchases a condo in FL in 2013 for $350,000 and proceeded to rent it out for both 2013 and 2014 (taking $20,000 in S/L depreciation). Then, upon selling their main home in MN in late 2014 for a $200,000 gain, they decide to move into their FL retirement condo (when the adjusted basis is $330,000 and there is a $20,000 suspended passive rental loss), living there full-time for all of 2015 and 2016. After this, the decision is made to buy a single-family residence. So, they sell the condo for $380,000 (realizing a $50,000 gain). What are the tax ramifications of these various transactions?

First of all, given that they meet the **Code §121** 2-out-of-5-year "use" and "ownership" tests, and have *not* claimed the exclusion in the prior 2 years, they can exclude the $200,000 gain on the sale of their first residence (i.e., the home in MN). Then, upon selling the FL condo for a $50,000 gain, 50% of this gain would be allocated to the period of "non-qualified use" (i.e., 2013 and 2014), or $25,000. But, this would be passive income and would be offset by the $20,000 suspended passive rental loss, for a net $5,000 Sec.1231 gain (i.e., taxed as "unrecaptured §1250 gain" at a 25% tax rate) which, absence any Sec. 1231 losses, would flow to **Form 8949** and **Schedule D** (and, which could be offset by any capital losses that the couple might have). But, assuming that the couple has no current (or, carryover) capital losses, this $5,000 gain would also be subject to the **Code §1411** 3.8% Medicare surtax (i.e., on **Form 8960**). On the other hand, the remaining gain of $25,000 allocable to their use of the FL condo as a principal residence can be completely excluded under **Code §121** (i.e., given that they again met the "ownership" and "use" tests, which they did, by only renting this home for less than 37 months during the 60-month period leading up to the date of sale).

Comment: Even if the FL condo was instead sold at a loss, it would still be considered a "complete disposition" of a former passive activity (FPA). Therefore, all of the $20,000 suspended rental loss would be freed up. And, the portion of the overall loss attributable to the rental portion (i.e., 50%, given the time-line mentioned above) would be taken on **Form 4797** as a Sec. 1231 ordinary loss. Meanwhile, the portion of the loss allocable to the personal use of the home would be nondeductible.

Example: Assume that the facts above were reversed insomuch as the FL condo was first used as a principal residence for two years and then rented out for the following two years before it was ultimately sold for a $50,000 gain (although there was again a $20,000 suspended rental loss as of the time of the sale).

Since the **Code §121** 2-out-of-5-year "ownership" and "use" tests were met (and, no exclusion was claimed for the prior two years), the *entire* $50,000 gain would be excluded except for the $20,000 attributed to the depreciation claimed on the rental use of the home. But, with the $20,000 suspended passive loss freed up by this "complete disposition," the "unrecaptured §1250 gain" of $20,000 would be entirely offset.

Comment: The difference in this second example is that Congress deemed that any "non-qualified use" leading up to the date of sale would *not* be considered, as long as the taxpayer did *not* re-establish this home as their "principal residence" before selling it. For instance, in a situation where a taxpayer has accepted a new job in a distant city and puts their home on the market. But, having trouble selling it (i.e., especially in the recent recession), they are forced to rent it out to generate some cash flow to assist in continuing to pay the mortgage and taxes. But, if they eventually sell it (and, if it is within 36 months of moving out of the home), they can still qualify to exclude the entire gain, if any, on sale pursuant to **Code §121** (except for any "unrecaptured Sec. 1250 gain" resulting from depreciation taken during the rental period). And, given that this is a "complete disposition" of a former passive activity, any current or suspended rental loss would also be allowed. (**Cf. CCA 201428008**) **(Code §§121 & 469; Home Sale Exclusion & PALs)**

☞**Suspended Losses Allowed on Disposition of Rental Property Converted to Principal Residence**

Facts: A taxpayer has a rental property that he converts to a principal residence. He has passive activity loss carryovers. He sells it and excludes the gain because it is less than the $250,000/500,000 exclusion (i.e., assume that he has met the 2-out-of-5-year test). Tax will still have to be paid, however, on the unrecaptured Sec. 1250 gain to the extent of any post-5/6/97 deductions taken (i.e., at at 25% rate). But, assume that there has been some "nonqualified use" (i.e., used as other than a principal residence after 2008), but this property has *not* been the subject of a like-kind exchange in the prior five years.

Issue: Are the passive loss carryovers deductible in the year of sale of the residence, or do they disappear when he converted the property to a personal residence?

Discussion: The IRS considered a similar issue in the context of the former rollover provision of **Code §1034** in **PLR 90039004**. The inference is that, in the context of **Code §121**, the suspended losses should be allowed to the extent of any gain recognized (i.e., due to the post-2008 "non-qualified use"). However, this is a arguably a gray area which does *not* appear to be covered in the regs or any IRS ruling. Although **Code §469(g)** technically requires that the disposition be a "fully taxable transaction" before any suspended losses may be claimed (i.e., in the absence of any passive income from other sources in the interim), it makes sense to allow suspended losses to be claimed in a **Code §121** transaction at least to the extent that gain is recognized as a result of the previously claimed depreciation (i.e., post-May 6, 1997 depreciation) from which no tax benefit was recognized under the passive activity rules. But, the IRS has come out with **CCA 201428008** which states that this would be a "disposition" for purposes of the passive loss rules. So, any suspended PAL losses (perhaps from the former use as a rental property) would free up regardless of any gain being excludible under **Code §121**. **(Code §469; Suspended Passive Losses)**

Comment: If this example instead involved a second or vacation home, then the disposition would have been in a "fully taxable transaction." As a result, not only would the gain from any post-5/6/97 depreciation have to be taxed (i.e., as Sec. 1250 unrecaptured gain at a 25% tax rate), but also the totality of any other gain (i.e., as a capital gain). Thus, any suspended losses remaining from the time that this was a rental property (i.e., still listed on **Form 8582**) would be freed up.

☞**Passive Loss Recharacterization Rules and Co-Ownership of Building**

Assume that two unrelated individuals each 100% of their respective S corp accounting firms. Having leased their premises for several years, their firms decide to go in together toward the purchase of a building. For limited liability purposes, ownership of the building by their companies as tenants-in-common was put into two separate SMLLCs (which, of course, are ignored when filing the Form 1120S).

The building had two floors with each of the S corp accounting firms taking one floor apiece. Furthermore, each company reported their share of the building's depreciation on Form 4562 (i.e., as 39-year MACRS commercial property), along with their share of real estate taxes and other building maintenance and repair costs. However, each floor had their own utility hook-up and HVAC units, so these costs were recorded separately.

For purposes of the passive loss rules, each owner materially participated in the accounting trade or business of their respective S corporations. So, regardless of the how the costs related to the building might serve to create (or, increase) an NOL, it would never be considered passive for purposes of **Code §469** (nor would, of course, any income be treated as passive).

> **<u>Comment</u>:** The tax treatment discussed above should *not* change if the two S corps were to decide to form a separate LLC to merely hold title to the building (i.e., a mere nominee) and no rental situation were to be created (i.e., on Form 8825). In other words, the two S corps would continue to account for their share of the building's depreciation on separate Forms 4562 on each of their respective Forms 1120S, along with share of any related expenses.

> **<u>Comment</u>:** Before the advent of LLCs in the mid-90's, along with the repeal of the ***General Utilities*** doctrine after TRA '86, it was *not* uncommon to use C corporations as "mere nominees" to hold title to real estate and thereby provide limited liability protection for such a valuable asset. And, even then, the use of such assets was still reported directly on the related business returns (or, in some cases, on a Schedule E as rental real estate by the landlord who controlled the property). For example, in a rental situation, all rental checks were made out to the Schedule E landlord, while expenses were also paid by this individual. So, for all intents and purposes, their was little outside evidence that the C corporation holding title even existed. And, when the building was eventually sold, it was on the individual landlord's Form 1040 that any gain or loss would be reported.

Now, change the example to a situation where instead it is the two individual owners of the respective S corps who form an LLC to make the purchase of the building with each S corp owner also owning 50% interest in the LLC with the intent to rent the building back to each of their companies (i.e., the building is now leased under two separate leases to each accounting firm).

Two separate issues arise from a tax standpoint. First, how would the rental income coming from the LLC to these two S corp owners (i.e., via Box 2 of their respective K-1s) be characterized for passive loss purposes? And, if there was to be a consistent pattern of significant rental losses expected over a 3- to 4-year period (or, a one-time loss from a cost segregation study), could a grouping election be made so as to make the resulting net rental loss nonpassive?

Assume that each S corp business pays the same rent per square foot for an equal amount of space. As a result, since half of the rental income to each owner of the LLC is coming from the *other owner's S corp accounting firm*, only half of the rental income would be recharacterized as being nonpassive income (i.e., since only this portion of the rental income came from the LLC's own S corp in which they materially participated).

As to a possible grouping election, this might be a bit more difficult to discern. Technically, there is *not* "identical" ownership of each S corp business and the LLC which leases the building. In other words, this is *not* the typical situation where A and B each own 50% of a trade or business while also owning 50% each of the LLC holding title to the real estate. However, under the recent ***<u>Candelaria</u>*** decision, an argument could be made that each owner's share of the gross rents paid to the LLC is "insubstantial" (i.e., less than 20%) of the total gross receipts of that owner's S corporation. As a result, a grouping election to combine each S corp's trade or business activity with the respective rental activity within the LLC would constitute an "appropriate economic unit." Then, any rental loss flowing from the LLC to each owner would be treated as nonpassive as well. **(Code §469; Passive Losses)**

☞Grouping of Rental Activities With Related Trade or Business Activities for the Passive Loss Rules

Reg. §1.469-4(d)(1)(i)(C) permits certain groupings of two activities where there is *identical* ownership of *both* activities. For instance, a taxpayer owned 100% of the building in a SMLLC while also owning 100% of an S corporation which conducted a profitable restaurant trade or business. Assume that with a $200,000 additional depreciation caused by a "catch-up adjustment," this negative adjustment (which would have to be taken all in one tax year per **Rev. Proc. 2002-19**) would result in a net rental loss for the current tax year. However, by grouping (and, assuming that this combination was an "appropriate economic unit"), the rental loss could be offset by the K-1 income from the S corp being shown on page 2 of the same Schedule E (as well as flowing over to page one of his Form 1040 where it also offset his other "active" and "portfolio" income). In other words, the rental would no longer be looked at as a *separate* activity that would be *automatically* passive. Instead, it would become part and parcel of the overall trade or business activity in which the taxpayer was materially participating (i.e., and, therefore, *nonpassive*).

> **Comment:** As discussed below, and as decided by the Tax Court in ***Senra*, TC Memo 2009-79 (4/15/09)**, even where there is "identical" ownership, a grouping of a "rental activity" with a "trade or business activity" is *not* going to be allowed so as to negate the application of the passive loss rules where the "trade or business activity" is conducted through a C corp (either a closely-held or personal service C corporation). As emphasized by the ***Senra*** decision, such a grouping combination only can be used to show whether or not the taxpayer materially participated in the "other activity." And, if the "other activity" is a "rental activity" (which is deemed to be automatically passive regardless of the level of the taxpayer's participation, unless the "real estate professional" exception otherwise applied), this would be a futile effort.

Appropriate Economic Unit: The reason that grouping two activities as just one for purposes of the passive loss rules makes sense can perhaps be explained by the following example. Suppose John and Rod equally owned their accounting practice which operated as an S corporation or an LLC. Back in the "old days" (i.e., during the 1970s and 80s), the concept of owning real estate in an LLC was unheard of. Instead, this real estate was simply another asset listed on the business' Schedule L balance sheet. And, when the passive loss rules came out in the '86 TRA, both John and Rod would be considered "materially participating" in their business. As a result, even if this real estate owned by their business generated a great deal of expenses (i.e., due to maintenance and repairs, insurance, taxes, depreciation, etc.) and, maybe, helped to create or increase an NOL for the business, this net loss would *not* be subject to the passive loss rules when it flowed through on each of their respective K-1s and over to their personal returns. This is due to the fact that they material participate in their business. So, if they subsequently decided to instead hold their real estate in a separate LLC, for instance, to provide protection from creditor claims or lawsuit judgments, why should this produce a different result for purposes of the passive loss rules? They still own the business (whether it be an S corp or an partnership/LLC) in *identical* proportions. That is why the writers behind the passive loss regs provided for this "appropriate economic unit" exception which is achieved by making a "grouping election." And, the fact that such an election was *not* in force in prior tax years does *not* mean that it cannot be made on a prospective basis.

Identical Ownership: There is some question as to the appropriateness of a **Code §469**

grouping election where there is *not* "identical" ownership of the "trade or business" activity vis-a-vis the "rental" activity. Although we do considered the attribution rules in various other sections of the Code, here, when determining whether two separate activities (especially where one is a *rental* activity) constitute an "appropriate economic unit," these legislative regs call for "identical" ownership in each activity. The plain meaning of this requirement or term would appear to prohibit a grouping election, for instance, where the father owned 100% of the business activity (in which he materially participated), but his son owned 100% of the rental activity. Though the attribution rules would consider their relationship as being common ownership for certain other purposes of the law, it does *not* seem to be the intent behind these regs for purposes of the grouping election and whether an "appropriate economic unit" exists. As a result, the grouping of these two activities would *not* be "appropriate" under these circumstances.

Example: In a recent situation, the parents each owned 40% of an S corp business, while their son owned the remaining 20%. However, the LLC which rented the real estate to the business was owned jointly by only the parents. After a cost seg study was done in 2009, the catch-up depreciation deduction would have produced a significant loss on the LLC return which, in turn, would flow to the parents Form 1040, resulting in an NOL which could have been carried back up to five years (i.e., given that the passive loss rules did *not* apply). However, lacking "identical" ownership in each entity, the parents would have been barred in making a grouping election so as to negate the impact of the PAL rules. As a result, the net rental loss would have to be suspended as a passive loss on Form 8582 for the 2009 tax year.

Example: Assume the same facts as in the example above except that, early in 2010, each parent gifted 10% of their LLC interest to their son, now resulting in "identical" ownership of the LLC with the family's jointly-held business entity. The result would be that a grouping election which would now be allowed for 2010. Nevertheless, this election would *not* mean that the suspended rental loss (i.e., from the 2009 catch-up depreciation deduction) automatically frees up (possibly producing an NOL on the parents' 2010 return to be carried back, at least for the normal 2-year period). Rather, the loss would now be considered from a "former passive activity." So, it would only be allowed to the extent of any K-1 income (or, any other "active," but *not* "portfolio" or "passive," income such as wages) from *either* the S corp or the LLC flowing through to the parent's return (i.e., where there suspended 2009 net rental loss resided).

Comment: The obvious planning point would be to delay filing the Form 3115 to catch-up on the missed depreciation discovered by the cost seg study until the 2010 Form 1065 return (with the **Form 8825**) was completed (and, the "identical" ownership of the two entities had been established). Then, a valid grouping election would be in force so that *both* the son and his parents could take advantage of the passive loss rules *not* being able to suspend this net rental loss flowing over on their respective K-1s from the LLC holding the real estate. Otherwise, if the Form 3115 was instead filed in 2009, but the grouping election was not available to be made until 2010, the parents would just be sitting there with a large suspended passive loss on Form 8582 which would be attributable to a "former passive activity."

Comment: It should be noted that the regs under **§1.469-4** make a distinction between grouping two "trade or business" activities vs. a "trade or business" activity and a "rental" activity. With the *former* situation, one only needs to have "common control" or "common ownership" to arguably make a grouping election to have the two "trade or business" activities be counted as just one activity for purposes of the passive loss rules. This might be advisable where, for instance, the taxpayer puts 300 hours into each activity for the tax year. But, to "materially participate," he needs to meet the "500-hour test" under **Code §469**. So, by successfully combining these two activities, he would avoid the passive loss rules. However, where a "trade or business" activity is to be combined with a "rental" activity, there must be "identical" ownership whereby *all* owners of each activity own the *same* proportional interests in both.

Consistency Requirement: As far as the "consistency requirement" outlined in **Reg. §1.469-4(e)**, the mere fact that the tax prep software was recharacterizing any net rental *income* (i.e., which is what had occurred up until the tax year that this "catch-up depreciation was to be claimed) as "nonpassive" income (and, therefore, it would have flowed directly to page 1 of Form 1040 and *not* to Form 8582 first as a source of passive income), this should *not* in any way be considered as a "grouping election" that had already been made in a prior tax year. In other words, the taxpayer is *not* barred from what making a fresh grouping election, regardless of what they had done (i.e., or, what they were required to do under the "recharacterization" rules) in prior tax years.

Grouping Election Statement: An election statement should be sent in with the tax return that otherwise owns and operates the trade or business activity (or, rental real estate) which lists the taxpayer's name, EIN and the tax year for which it is to be effected. It should state that an election is being made to group activities pursuant to **Reg. §1.469-4(c)** and contain language similar to the following: "The taxpayer hereby elects to group the following activities together so that the grouped activities are treated as a *single* activity under the passive loss rules for the year ended __________, and all years thereafter." Furthermore, the election should state that "The following activities are to be grouped together and treated as *one* activity" (i.e., a listing should be included that indicates which activities are to be included). **(Code §469; Grouping Activities)**

Comment: Once the election is in effect, make sure the tax prep software does *not* allow this rental loss to flow to **Form 8582** (i.e., as it normally would without such an election being made). Instead, it should flow directly to page one of the Form 1040.

Code §529 - Qualified Tuition Programs:

☞Tax Treatment of Sec. 529 Distributions

Even though the taxpayer might receive a **Form 1099-Q**, withdrawals in 2021 from a Sec. 529 education savings account, such amounts are normally *not* taxable. These information returns are sent to account owners, as well as the IRS, to report distributions made during the year made from both Sec. 529 plans and Coverdell education savings accounts. Withdrawals from Sec. 529 plans used for post-secondary educational costs are tax-free as long as they cover eligible expenses which would include the cost of room and board for students enrolled at a college or university at least half-time, tuition, books, supplies, fees, computers and internet access. In addition, $10,000 per student per year can be taken from Sec. 529 accounts to pay tuition for elementary and secondary private schools (i.e., K-4 through 12th grade). Up to $10,000 can also be withdrawn over one's lifetime to help pay down college debt. Earnings (but, *not* the basis in such accounts) on Sec. 529 distributions used for other purposes are subject to income tax. **(Code §529; Sec. 529 Plans)**

☞Using Sec. 529 Funds to Pay for Off-Campus Housing

Funds in 529 accounts can be withdrawn tax-free for off-campus housing. But, there are some limitations such as the fact that the college student must be enrolled at least half-time. Also, they are not permitted to claim more than the room-and-board allowance that the college includes in the cost of attendance for federal financial aid purposes (which should be available on the school's website or from the financial aid office). Also included in the costs that are eligible for payment out of a Sec. 529 plan are food and routine utilities, as long as the total living costs, including rent, do *not* exceed the room-and-board allowance determined by the school. (**Code §529**; **529 Plans)**

> **Comment:** One of the mistakes made with Sec. 529 plans is to attempt to reimburse otherwise qualifying costs directly to the taxpayer/student after they have already paid for these types of expenses with borrowed student loan funds. If that occurs, then the deferred earnings portion of the expenditure out of the Sec. 529 plan is taxable.

Code §1031 - Like-Kind Exchanges:

☞**Bifurcated Tax Treatment of Like-Kind Exchange v. Outright Sale of Real Estate Not Allowed**
During the height of the recession we did not see (or, have to prepare) too many **Form 8824s** to report a like-kind exchange of real estate. With severely depressed values (especially if the property was originally purchased during 2005 to 2007), it made sense to simply sell the investment and take, oftentimes, an ordinary Sec. 1231 loss on **Form 4797**. But, now at least on the two coasts especially, we are seeing some extreme run-ups in values in real estate which are generating renewed interest in deferring these potential gains through a like-kind exchange.

Typically, the investor secures the services of a qualified intermediary who deposits and proceeds of the sale into an escrow account, thus avoiding having the taxpayer come into actual (or, constructive) receipt of the underlying monies involved in the transaction. Then, within 45 days in writing, potential qualified replacement properties are identified with the acquisition of these occurring within 180 days (i.e., a "deferred ***Starker*** exchange). And, if no boot is received (i.e., cash, other property or excess mortgages relieved of), the basis of the newly-acquired replacement property is the same as the property relinquished.

Consider, though, the following example where the taxpayer is approached by a potential buyer who offers some money as a down payment but asks if this seller would be willing to take back an installment note.

> **Example:** In the NYC area, the taxpayer acquired a post-'86 MACRS property for $250,000 and, after holding it until recently, had accumulated depreciation of approximately $150,000 against it. Therefore, it currently had about a $100,000 adjusted basis when this potential buyer offered $3 million for this real estate. $1 million cash would be paid at closing with the taxpayer taking back a $2 million installment note which would be payable over 10 years with an adequately stated interest rate.
>
> The taxpayer accepted the offer of the $1 million down payment, keeping $200,000 at closing while allowing the remaining $800,000 to be placed into an escrow account held by a qualified intermediary. Furthermore, a successful "deferred Starker exchange" was consummated with this $800,000 balance and no boot being either given or received. How should this transaction be treated for tax purposes and, thus, be reported on the taxpayer's return?

Even though a like-kind exchange was successfully executed, at least with regard to $800,000 of the initial down payment, the transaction would *not* be bifurcated for tax purposes as a part LKE and part outright sale. Instead, the **Code §1031** like-kind exchange rules would control. In other words, this would be a LKE where an additional $2.2 million of boot would have been received (i.e., $200,000 of cash boot and $2 million of boot in the form of the installment note).

As a result, the taxpayer would have a recognized gain of $2.2 million on the payments received (i.e.,

$200,000 in the year that the transfer of the property occurred, and over the ensuing 10-year period of the installment note), while the remaining $700,000 of gain is deferred (i.e., $800,000 of proceeds successfully reinvested in qualified replacement property less the $100,000 adjusted basis in the property that was exchanged).

There would be no need to calculate a "gross profit percentage" with regard to the installment note (i.e., it would be 100%) since the *entire* $100,000 adjusted basis in the property exchanged would carry over to the qualified replacement property. Instead, the taxpayer would simply have to include the entire $200,000 cash received as recognized gain in the year of sale, with the remaining $2 million of installment payments being recognized at a rate of $200,000/year over the ensuing 10-year period. However, the preamble to the **Reg. 1.1031** regulations makes it clear that the installment method would be allowed when a note is taken back in a **Code §1031** like-kind exchange. (Cf. **TD 8535** and **Reg. §1.1031(k)-1(j)(2)(iii)**)

Because of the $100,000 in accumulated depreciation taken, the first $100,000 of recognized gain would be taxed as "unrecaptured Sec. 1250 gain" which, given the taxpayer is in a marginal tax rate of 25% or more, at 25%. Then, once this first $100,000 of gain is included in income (which will occur in the very first year, given that the entire $200,000 of the initial $200,000 down payment is taxable), the remaining $2 million gain will be taxed as Sec. 1231 gain at either 15% or 20% (under the current tax law).

It should be noted that *either* type of gain (i.e., "unrecaptured Sec. 1250 gain or Sec. 1231 gain) flows from **Form 4797** to **Schedule D** to determine net capital gain or loss for the year of sale. As such, *both* types of gain are eligible to be offset first against any capital losses that this taxpayer might have. And, if there is any excess of these two types of gain (which would be used pro rata against any capital losses), then the applicable tax rates would be 25%, 20% or 15% as mentioned above.

Furthermore, this overall gain of $2.2 million, given a passive activity was involved (e.g., this building had been a rental property while the taxpayer held it) would also simultaneously serve as a source of passive income which could be used to offset either current or suspended losses on **Form 8582**.

As a side note, this building had been held jointly by a married couple, but the husband died just a few months after the sale occurred with the wife inheriting his half of the installment note. Nevertheless, since these proceeds represent "income in respect of a decedent," there would be no step-up in the basis of the note inherited by the surviving spouse. As a result, the 100% gross profit percentage as calculated above would *not* change.

> **Comment:** "Income in respect of a decedent" does *not* only include cash-basis receivables that the taxpayer may have billed in his business before he died, for instance, but which remain uncollected as of the date of his death. The term IRD also applies to IRA and retirement plan monies that one might inherit (with both of these sources retaining the character of ordinary income that they would have received had the taxpayer lived to collect them). It also includes *any* type of receipt such as proceeds yet to be received as of the date of the taxpayer's death on the sale of a Sec. 1231 property (e.g., rental real estate) or a capital asset (e.g., stock in an S corporation).

Summary: Many like-kind exchanges involved the seller receiving all of the proceeds at closing (i.e., a potential buyer would come to closing having secured the necessary financing to acquire title to the property outright). But, as seen in this recent transaction, the seller was forced to accept an installment note, along with a sizable down payment, in order for the deal to be consummated. But, given that he at least placed $800,000 of the total $1,000,000 down payment into an escrow account held be a qualified intermediary, and proceeded to properly carry out a deferred Starker exchange, he could at least avoid some of the realized gain on the transaction being recognized by using **Code §1031**.

Code §1411 - 3.8% Medicare Surtax:

☞**Impact of Passive Loss Rules on 3.8% Medicare Surtax**

The 3.8% Medicare surtax has been with us since the 2014 tax year. When first being considered by Congress, it was suggested that it be applied against the *same* "net investment income" amount as that used on **Form 4952** when determining to what extent investment interest expense could be deducted (i.e., pursuant to **Code §163(d)(3)**) on **Schedule A** (i.e., assuming the taxpayer was itemizing their deductions). But, estimating that enough tax revenue would *not* be generated, it was decided that "net passive income" be also added to the mix. As a result, it is critical when calculating the surtax on **Form 8960** that we first determine if the taxpayer has any passive income sources on their return.

> **Comment:** Even without the addition of net passive income to overall "net investment income" for purposes of the surtax, the **TCJA** made a major change when it suspended 2% miscellaneous deductions, as well as instituting the $10,000 SALT cap. Some wealthier taxpayers pay significant management advisory fees while also having their investment and passive income subject to state and local income tax. Now, the "net" number for this base on which the 3.8% surtax will be imposed will be much higher for many taxpayers (i.e., since these deductions will *not* come into play as offsets to "gross investment income").

The following illustrations demonstrate the interconnected effect of the **Code §469** passive loss rules and the **Code §1411** Medicare surtax. Depending on whether a taxpayer has a greater need for passive income (especially where they also have significant passive losses), or otherwise wants to instead avoid the 3.8% surtax, some critical tax should be considered.

> **Example: "Retirement from Nonpassive Business"**
> The parents who own 100% of their "nonpersonal-service" S corporation (or, partnership) want to retire and start handing over the control of company to their son or daughter. To do so, they initially transfer 10% of the company to their children, while maintaining control to ascertain how this arrangement is going to turn out. Now, while in retirement they continue to receive sizable profits passed through to them as K-1, Box 1 "Trade or Business Income." But, for the first 5 years of retirement, they are considered to continue to "materially participate" in the underlying activities of the company. Therefore, this income is *not* subject to the 3.8% surtax. Nevertheless, in the 6th year of their retirement (again, this is a "nonpersonal-service T/B"), this "five-out-of-previous-10-year test" for material participation would no longer be met meaning that the surtax would now be imposed on these business profits.
>
> **Comment:** If the parents in the above **Example** needed a significant source of passive income (e.g., they have sizable rental losses and they are *not* "real estate professionals"), they might look forward to Year 6 of their retirement when most of this now K-1 passive income can be used to offset their passive rental losses.
>
> **Comment:** Keep in mind that with a "personal service" business such as a law, medical, accounting firm, etc., material participation in *any* prior tax year will forever taint the activity (and, therefore, any income derived from it) as being *nonpassive*. Distinguish this test from the M/P test where you instead look to "any five of the prior ten years" to determine for how long an activity continues to be nonpassive.

<u>Example</u>: "Sale of Nonpassive Business with Self-rental Real Estate in LLC"
The owners of a "nonpersonal-service" business (e.g., manufacturing) in Cleveland, OH decide to sell the company while retaining the real estate held in their jointly-owned LLC which will now be rented to the new owners. Given that they materially participated in this business, the multi-million dollar gain on the sale of the business would *not* be subject to the 3.8% Medicare surtax.

<u>Comment</u>: If this company had instead been a C corporation instead of an S corporation or partnership (or, unincorporated business), then the material participation of these owners would *not* have been taken into account and either the sale of the C corporation stock, or a sale of its assets, would be subject to the surtax (i.e., as "portfolio income"). One could instead make an S election shortly *before* the contemplated sale and the material participation of the owners would now count so as to make the business activity nonpassive (and, therefore, *not* subject to the surtax). But, then you would have to contend with the **<u>Code §1374</u>** "built-in gains" tax.

<u>Example (Cont'd.)</u>: After just 9 months of retirement these former owners of the Cleveland company found out that being a "landlord" (even with the help of an outside property management company) was more than they could handle. So, the new owners of their former business agreed to buy this real estate resulting in another multi-million dollar gain. The trouble now was that this sale was to an outside third party in whose business the former owners no long had any involvement. Thus, the gain was subject to the surtax because it is no longer a "self-rental" activity in which they were materially participating in the underlying tenant's business to which the property was being rented.

<u>Comment</u>: Had these owners sold *both* the business and the "self-rented real estate" in *same* tax year, then their years of materially participation in the business would have also recharacterized the LLC rental activity as nonpassive as well, with the result being that the surtax would *not* have applies to any of the gains.

<u>Example</u>: "Sale of Part Self-rental & Part Unrelated Tenant Property Held by LLC"
A and B hold a commercial building in an LLC which leases it to their business in which they materially participate (i.e., a nonpassive "self-rental" activity), as well as several other unrelated third-parties. The building is sold for a multi-million dollar gain. How much, if any, of this Sec. 1231 gain would be subject to the 3.8% Medicare surtax?

Using some reasonable allocation method, the portion of the gain attributable to the "self-rental" portion of the building would be a *nonpassive* activity and would, therefore, escaped the surtax. Nevertheless, assuming that A or B are *not* "real estate professionals" (i.e., so that the remainder of this LLC's rental activity is *passive*), this portion of the gain on sale (let alone, a portion of the year-to-year rental income) would be hit with the 3.85 Medicare surtax.

<u>Example</u>: "Taxpayer Not in Need of Passive Income - Eats, Sleeps and Breathes Real Estate"
Assume that a taxpayer has over 150 rental properties spread throughout the U.S. The net rental income that they generate each year is approximately $1 million. Furthermore, assume that the taxpayer does *not* have any significant net passive losses each year (i.e., that might end up suspended on **<u>Form 8582</u>** given that he does *not* have sufficient passive income).

The taxpayer in this instance clearly meets the tests as a **"real estate professional"** under **<u>Code §469(c)(7)</u>**. But, it would be difficult to prove that he materially participates in each and every one of his rental activities. As a result, a valid "grouping election" is made so that the various rental property are treated as just *one* activity for purposes of the passive loss rules. More importantly, given that he has already satisfied the 750-hour REP test, he would clearly satisfy the "500-hour"material participation test for this *one* activity under the PAL rules.

The bottom line is that he will save approximately $38,000 each year by *not* having to pay the 3.8% Medicare surtax on his $1 million of net rental income (i.e., which is now treated as being *nonpassive*).

Comment: Of course, if this taxpayer had significant passive losses in need of passive income to offset them, then consideration should be given to *not* making the "grouping election" and instead net most (if not all) of what would now be passive rental income with these passive losses (i.e., thus, *not* subjecting any net rental income to the surtax, while also being able to currently deduct his other passive losses).

Comment: Maybe the even bigger consideration from a tax standpoint of making the "grouping election" and having *not* only the net rental income each year *not* be subject to the surtax, is that any Sec. 1231 gain on the sale of these properties would even be much greater and would also escape the surtax.

PARTNERSHIP/LLC TAXATION:

Miscellaneous:

☞**Revised Form 1065 Schedules K-2 and K-3 Instructions**

The IRS has revised the **Schedule K-2 (Partners' Distributive Share Items—International)** and **K-3 (Partner's Share of Income, Deductions, Credits, etc.—International)** instructions for **Form 1065**. The revised instructions made changes to the "domestic filing exception" that provides an exception to filing **Schedules K-2** and **K-3**. The key changes made to the domestic filing exception in the new draft instructions include: (1) the notice to partners no longer must be issued by 1/15/23 (i.e., the notice can be furnished with the K-1); (2) the 1-month date (i.e., for when a particular can request a copy of the **Schedule K-3**) will now be as late as one month before the **Form 1065** is actually filed, as late as 8/15/23, for extended calendar year returns; and (3) the list of U.S. citizen or resident alien partners is now expanded to include S corporations with a single shareholder and single member LLCs whose owner is listed as an eligible U.S. citizen or resident alien partner. **(Misc.; Schedules K-2/K-3)**

☞**Instructions for Schedule K-1 Released**

Instructions for **Schedule K-1** were released on 12/9/22. Changes to the form include: (1) international transactions new notice requirement, (2) additional information required for IRA partners with respect to "unrelated business taxable income," and (3) **Schedule K-1** no longer has page 2 with the list of codes. The list of codes and descriptions are now provided at the end of the partner's instructions. Related to the international transactions new notice requirement, if **Box 16** is *not* checked, partners should receive notification from the partnership that they will *not* be receiving a **Schedule K-3** unless they request one. (Misc.; Schedule K-1)

☞**Updated W-9 with New Requirement for Flowthrough Entities**

The IRS released an updated draft of **Form W-9** with a new requirement for flowthrough entities. A *new* **Line 3b** has been added to the form requiring flow-through entities to indicate if they have direct or indirect foreign partners, owners, or beneficiaries. This change will inform partnerships receiving **Form W-9** that they have a **Schedule K-3** reporting requirement with respect to sales of partnership interests. The new form also would inform domestic partnerships whether they have an indirect foreign partner, and therefore would be required to notify the lower-tier partnership within 30 days of divestment that the domestic partnership requires the **Schedule K-3** information. **(Misc.; Form W-9)**

> **Comment:** The draft **Form W-9** was released on 7/26/23 and shows a revision date of October 2023. Once the form is finalized, withholding agents are generally required to accept and use the current version of **Form W-9**.

☞**Service Pledges More Audits of Flowthrough Entities**

There is no question that audits of partnership entities by the IRS have been deplorable in recent years. Currently, the Service audits less than 2 partnership returns out of every 1,000 Form 1065s filed (i.e., less than 0.2%). Even then, about 50% of exams result in no change to taxes at the partner level. As a result, the IRS has pledge to improve these figures and bring in additional tax revenues by dramatically increasing its enforcement efforts.

The Service has announced that it will be hiring more revenue agents, tax law specialists and attorneys with experience in pass-through entity taxation to work on audits involving large partnerships and LLCs. It has also made changes to the **Form 1065** and is updating its models for selecting partnership returns to audit. Targeted compliance campaigns will focus on some of the more complex issues relating to partnerships and their owners. One of the key issues that IRS auditors will take an in-dept look at involve large losses claimed by partners on their 1040s.

Comment: Right now, **Form 7203** is required as an attachment to Schedule E, page 2 whenever an S corporation share hold claims a K-1 loss, receives a distribution, disposes of their stock or receives a repayment of a loan made to the S corporation. Nevertheless, there is currently no similar form for partners.

The Service is concerned that partners claiming flow-through K-1 losses from partnerships on their individual returns might *not* have sufficient adjusted basis in their partnership interests to do so (or, the at-risk and passive loss rules have not been properly taken into account). Another key issue is whether partners who sell their partnership interests are properly determining not only the amount of the gain or loss, but also the character of such gain or loss (i.e., pursuant to **Code §741** and **751**.

Centralized Audit Regime: The IRS was hoping that its new "centralized partnership audit regime" would result in a significant increase in the audit of more partnerships, as well as making it easier to collect any additional taxes owed. Many larger partnerships have multiple levels of ownership, with hundreds or thousands of partners. Previously, when the Revenue Service examined one of these huge partnerships and proposed changes, it had to track down each and every partner and make the adjustments to their respective returns. That required more personnel and resources than the agency otherwise had available.

This approach applies to partnership returns filed for tax years beginning after 2017 and allows the IRS to audit the partnership's tax return and collect any tax due solely from the partnership entity and not each individual partner. The partnership can then elect to push out the tax to the partners on record for the audited tax year by issuing adjusted **Forms K-1** to them with the partners then taking the changes into account on their own tax returns.

Partnerships with 100 or fewer partners can elect out of these centralized audit rules (unless a trust is one of the partners). **IRS Pub. 5388** for a one-page road map on the process, time frames and other pertinent information. Nevertheless, this new audit program has failed to make a dent in IRS's "no-change rate." As a matter of fact, it is even worse now. In 2019, the IRS began auditing selected 2018 **Form 1065s** under the new regime and closed 78% of those exams with no change to taxes, Treasury inspectors stated in a recent report. The Service agrees with the GAO that the no-change rate is too high, but it continues to insist that "it is too early to reach any definite conclusion about that finding." **(Misc.; IRS Audits)**

☞**IRS Establishes New Work Unit Focusing on Flowthrough Entity Compliance (IR 2023-176)**

The IRS has announced plans to create a special division to focus on partnerships and S-corporations as well as other large or complex pass-through entities. The IRS claims that the new work unit will use funding from the **Inflation Reduction Act** to stop attempts by a few large partnerships to use pass-through entities "to purposefully shield income to avoid paying taxes they owe." This new unit will be housed in the **IRS Large Business and International (LB&I)** division. This new group is expected "to assist the IRS follow through on its promised enforcement campaigns," as many of the LB&I campaigns concentrate on pass-through entities. **(Misc.; Pass-through Entities)**

Comment: Formal operations for the new unit are anticipated to begin in late 2024.

☞**IRS Centralized Partnership Audit Website (IR 2020-199)**

The IRS has launched its **Bipartisan Budget Act (BBA) Centralized Partnership Audit Regime**

website. Under the BBA, which is generally effective for tax years beginning January 2018, the IRS generally assesses and collects any understatement of tax at the *partnership* (v. individual partner) level. The new website is intended to be a "one-stop location" for anything BBA-related, including regulations and other guidance and instructions related to the Partnership Representative (PR), electing out of the centralized audit regime, Administrative Adjustment Requests (AARs), and what to expect during a BBA administrative proceeding. The IRS hopes that taxpayers "will visit the website often" for information, including electronic submission instructions of forms related to a BBA examination (when those instructions are available).

The Service has also developed a flowchart in its efforts to explain this program. It provides a reminder that a partnership can opt to push out the adjustment with the associated tax to the partners on record for the audited tax year by issuing adjusted Forms K-1 to them. The partners would then take the changes into account on their own tax returns. Partnerships with 100 or fewer partners can opt out of these audit rules. **IRS Pub. 5388** provides a "one-page road map" on the process, time frames and more. **(Misc.; IRS Audits)**

☞IRS Releases Domestic Filing Exception to Schedules K-2 and K-3

The IRS is offering a *new* "filing exception for purely domestic partnerships" in the draft version of the **2022 Partnership Instructions** for **Schedules K-2 and K-3 (Form 1065)**. A "domestic partnership" (as defined under **Code §7701(a)(2)** and **(4)**) will *not* need to complete and file with the IRS the **Schedules K-2** and **K-3** or furnish to a partner the **Schedule K-3** [except where requested by a partner at least one month before the due date (without extension) of **Form 1065** (i.e., the "one-month date") if each of the following four criteria are met with respect to the partnership's tax year 2022: (1) No or limited foreign activity, (2) Only U.S. citizen/resident alien partners, (3) Partner notification, and (4) No 2022 **Schedule K-3** requests by the one-month date.

> **Comment:** Further guidance and examples concerning the need for reporting by partnerships with domestic activity and with partners who are U.S. persons are available on the IRS **website**.
>
> **Comment:** There has been no mention, thus far, that any additional "domestic exception" applies for the 2023 tax year. This current one seemed sufficient for the 2022 tax busy season, as indicated by far less complaints regarding this filing requirement.

Form 1116: Individuals with sources of foreign income (or, who have otherwise paid foreign taxes directly, or through a flowthrough entity) are usually required to file **Form 1116** in order to claim the foreign tax credit on their personal tax return.

Schedules K-2 and K-3: When a partnership or S corporation has foreign sourced income, expenses, assets or tax the entity is required to fill out the 19-page **Schedule K-2** for the entity with each owner receiving the 20-page **Schedule K-3** reflecting their respective share of the entity's foreign activity items.

Waiver for 2021 Tax Year: For the 2021 tax year the IRS waived the filing requirement in **Notice 2021-39** for most "small partnership and S corporations" if the entity met a few basic requirements. A similar waiver is also applicable to returns filed for the 2022 tax year (i.e., "**Form 1116 Exemption**" discussed more fully below). Nevertheless, the penalty for failure to file these schedules was $280 for each **K-2** or **K-3** *not* filed where otherwise required, or where they were incorrect or incomplete.

Payments to Foreign Related Parties of Domestic Partnerships: Even with a partnership with no foreign source income, no assets generating foreign source income, no foreign partners, and no foreign taxes paid or accrued may still need to report information on **Schedules K-2** and **K-3**. For example, if the partner claims a credit for foreign taxes paid or accrued by that partner, the partner may need certain information from the partnership to complete **Form 1116** or **1118**. In addition, a partnership that has only domestic partners may still be required to complete **Part IX** when the partnership makes certain deductible payments to foreign related parties of its domestic partners.

Waiver for 2022 Tax Year: These new draft instructions waive the requirement for a partnership to file **Schedule K-2** and furnish partners with a copy of **Schedule K-3** if it is a domestic partnership and otherwise meets the following four rules:

> **Comment:** Since nothing specific has been issued regarding the 2023 tax year, this waiver should continue to apply.
>
> 1. The partnership has no foreign activity, or only passive foreign income (e.g., dividends or interest) that has less than $300 of foreign tax paid or withheld thereon and which is otherwise reported to the entity;
>
> 2. All 2022 owners are US citizens/US estates/US grantor trusts/regular trusts with only US citizen beneficiaries, or resident aliens;
>
> 3. The partnership notifies it partners by 1/15/23 (electronically or via mail, which is two months before the due date without extension) that no **Schedule K-3** will be prepared unless the partner notifies the entity of the need for the K-3; and
>
> 4. The partnership does *not* receive a notification from any partner of their need for a **Schedule K-3** by 2/15/23 (i.e., one month before the unextended due date of the entity's tax return).
>
> **Comment:** Keep in mind that any partnership with an S Corporation, C Corporation or another partnership owner does *not* meet this "domestic filing exemption" but might still satisfy the "**Form 1116 exemption**" discussed below.

Late Schedule K-3 Requests: If a partnership receives a request from a partner for the **Schedule K-3** information *after* the "1-month date deadline" (i.e., after 2/15/23) and has *not* received a request from any other partner for **Schedule K-3** information on or before 2/15/23 (i.e., the 1-month date), the "domestic filing exception" is deemed as being satisfied. As a result, the partnership is *not* required to file the **Schedules K-2** and **K-3** with the IRS or furnish the **Schedule K-3** to any of the *non-requesting* partners. However, the partnership is still required to provide the **Schedule K-3**, completed with the requested information, to the *requesting* partner on the *later* of the date on which the partnership actually files the **Form 1065** or one month from the date on which the partnership originally received the request from the partner.

Form 1116 FTC Exemption: If a partnership does *not* meet the "domestic filing exception," it may still meet the **Form 1116 Exemption** to filing the **Schedules K-2** and **K-3**. In other words, if the partnership has no direct or indirect partner that would be able to claim a foreign tax credit (or, who is otherwise exempt from filing **Form 1116** or **1118**). This **Form 1116 exemption** applies in situations such as when foreign taxes are all on passive income *and* amount to less than $600 MFJ/$300 for others in total FTC amount being claimed. Nevertheless, the partnership would still need a statement (or, a **W-8** or **W-9**) from every partner in this type of situation no later than 2/15/2023 (i.e., one month before the unextended **Form 1065** due date) as was the case for the 2021 tax year. **(Misc.; Schedules K-2/K-3)**

☞**2021 Filing Requirement for Schedules K-2 and K-3**

There has been a quite deal of consternation regarding these new schedules (19- and 20-pages, respectively) which might be required when filing either **Form 1065** or **Form 1120S** for the 2021 tax year. And, although the IRS has come out with some additional clarification and possible relief (as discussed below in **Notice 2021-39**), practitioners are still trying to cope with these new rules.

> **Comment:** This summary of the original waiver for the 2021 tax year is included for reference purposes. But the less strenuous 2022 (which should continue to apply for 2023 returns) is what is in play now.

In this ever-emerging global economy, it is reasonable for the IRS to be provided the information re:

1. Does the entity have any foreign owners (much like the various states needing a composite return to be aware of, and to have back-up withholding for, out-of-state owners to ensure that taxes are being paid)?

2. Does the entity have any foreign source items (income, losses, deductions, etc.)?

3. Does the entity have any foreign taxes paid that might be passed through to the owners in the possible calculation of their FTC on **Form 1116**?

The IRS has now released additional **Instructions** to provide clarification and guidance for **Schedules K-2** and **K-3**. The changes relate to the section entitled **"Who Must File"** and address the requirement for **Schedule K-2** and **K-3** completion for partners who may need certain information from the partnership to complete **Form 1116** **(Foreign Tax Credit)**. Also, a partnership with only *domestic* partners may still be required to complete **Part IX, Partners' Information for Base Erosion and Anti-Abuse Tax**, when the partnership makes certain deductible payments to foreign related parties of the domestic partners. The additional instructions address each part of the schedules with new or amended instructions.

> **Comment:** This same approach also applies to S corporations and the need to file **Schedule K-2** and **K-3**.

According to the IRS, the new **Schedules K-2** and **K-3** "improve reporting by standardizing international tax information to partners and flow-through investors, making it easier for them to report these items on their tax returns." In addition, the changes are intended to "ease flow-through return preparation compliance by clarifying obligations and standardizing the format for reporting."

Notice 2021-39 provides penalty relief for "good-faith efforts to adopt the new schedules." This transition relief takes the form of new frequently asked questions (**FAQs**) on **Schedules K-2** and **K-3**, allows an additional exception for tax year 2021 filing requirements by certain domestic partnerships and S corporations. To qualify for this exception, the following conditions must be met:

1. In **tax year 2021**, the direct partners in the domestic partnership are *not* foreign partnerships, foreign corporations, foreign individuals, foreign estates or foreign trusts.

2. In **tax year 2021**, the domestic partnership or S corporation has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated or may reasonably expected

to generate foreign source income.

3. In **tax year 2020**, the domestic partnership or S corporation did *not* provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):

- **Line 16, Form 1065, Schedules K and K-1 "Foreign Transactions"** (**Line 14 for Form 1120-S**), and

- **Line 20c, Form 1065, Schedules K and K-1 "Other Information"** (e.g., Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, section 250, section 864(c)(8), section 721(c) partnerships, and section 7874) (**Line 17d for Form 1120-S**).

> **Comment:** Additional detailed information regarding the changes made to the requirements for each schedule can be found at on the IRS website (i.e., **Form 1065** and **Form 1120S**).

4. The domestic partnership or S corporation "has no knowledge that the partners or shareholders are requesting such information for tax year 2021."

If a partnership or S corporation qualifies for this exception, the domestic partnership or S corporation does *not* need to file **Schedules K-2** and **K-3** with the IRS or with its partners or shareholders. However, if the partnership or S corporation is subsequently notified by a partner or shareholder that all or part of the information contained on **Schedule K-3** is needed to complete their tax return, then the partnership or S corporation must provide the information to the partner or shareholder.

If a partner or shareholder notifies the partnership or S corporation *before* the partnership or S corporation files its return, the conditions for the exception are treated as *not* having been met and the partnership or S corporation must provide the **Schedule K-3** to the partner or shareholder and file the **Schedules K-2** and **K-3** with the IRS.

> **Comment:** **IR 2022-38** has also been released by the IRS along with some **FAQs** on this issue but it essentially restates what was contained in **IR 2021-39**, while failing to add any significantly new insights.

☞IRS Issues Additional FAQs for Schedule K-2 and K-3

The IRS has added new **FAQs** related to various **Schedules K-2** and **Schedules K-3**. These additional FAQs are intended to clarify that affected partnerships and S corporations "need complete only the forms' relevant portions," while also addressing an array of special circumstances. The **FAQs** relate to *both* **Form 1065** and **Form 1120S** and include the following:

- FAQ 19: The partnership or S corporation does *not* qualify for any exceptions otherwise provided for in previous FAQs. Is the partnership or S corporation required to complete *all* parts of Schedules K-2 and K-3?

> **Comment:** New **FAQ 19** builds on a crucial earlier one, **FAQ 15**, in which the IRS outlined the scope of an exception for tax year 2021 to filing the schedules for certain entities. Entities that do *not* qualify for that exception may nevertheless *not* have to fill out the schedules in their entirety. It refers to the forms' instructions stating that entities "need only complete the relevant portions" of Schedules K-2 and K-3. Other new questions as outlined below concern which parts of the forms must be completed by affected entities of several types and in several unique

circumstances.

- FAQ 20: A filer otherwise required to file **Forms 5471**, **8865**, and/or **8858** may qualify for an exception from filing those forms based on the Internal Revenue Code, IRS guidance, and/or instructions to those respective forms (e.g., the "multiple filer exception"). If the filer qualifies for such exception, do the Instructions to the **Schedules K-2** and **K-3** nevertheless require a filer to complete **Forms 5471**, **8865**, and/or **8858**?

- FAQ 21: In **Part II, Section 1 (Description)** and **Part III, Section 4, Lines 1** and **3** of **Schedules K-2 and K-3**, is it possible to enter the code "RIC"?

- FAQ 22: When must a filer complete **Section 1** of **Part III, Schedules K-2** and **K-3**?

- FAQ 23: If a foreign partnership has passive foreign investment companies (PFICs) for which a mark-to-market (MTM) election described in **Reg. §1.1291-1(c)(4)** has been made (e.g., under **Code §475**), does the filer need to report the PFICs on **Part VII** of **Schedules K-2** and **K-3 (Form 1065)**?

- FAQ 24: Are **Part VIII (Form 1065)** and **Part VII (Form 1120S)** of **Schedules K-2** and **K-3** required to be completed for dormant foreign corporations (i.e., as defined in **Rev. Proc. 92-70, Sec. 3**)?

- FAQ 25: How should a partnership report its accrued original issue discount (OID) and OID income taxable on a gross basis to a foreign partner on **Section 1** of **Part X** of **Schedules K-2** and **K-3 (Form 1065)**?

- FAQ 26: Could you clarify the reporting on **Section 3, Lines 2b, 3a**, and **3b, of Part X, Schedules K-2 and K-3 (Form 1065)**? **(Misc.; Schedules K-2 and K-3)**

☞**Summary of Schedule K-2 and K-3 Filing Requirements**

A. Introduction

1. This summary addresses completion of **Schedules K-2** and **K-3** for 99% of business clients

    a. Focuses on domestic (U.S.) partnerships (and S Corps) with entirely-owned U.S. operations, income and assets

2. "Domestic operations" would include:

    a. No direct partner (in domestic partnership) is a foreign partnership, foreign Corp, foreign individual, foreign estate or foreign trust

    b. No foreign activity

    c. No foreign taxes paid (or accrued)

    d. No ownership of assets that generate, have generated or may reasonably expected to generate foreign source income

    e. Domestic partnership w/no foreign activity or foreign partners has direct or indirect domestic corporate partners*

f. Domestic partnership has an indirect partner that is a foreign partner**

*Triggers K-2, K-3 Part IV (i.e., Foreign-derived intangible income), and Part IX (i.e., base erosion anti-abuse tax) reporting (FAQ 14 (02/16/22))

Triggers K-2, K-3 Part X (i.e., effectively connected income), and Part XIII (Code §864(c)(8)**)

g. Not required to file either:

1) Form 8858 (Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (Fbs));

2) Form 8865 (Return of U.S. Person re: Foreign Partnerships);

3) Form 8804 (Annual Return for Partnership Withholding Tax (**Code §1446**)); or

4) Form 8805 (Foreign Partner's Info Statement of §1446 Withholding Tax)

3. New IRS requirement that ALL partnerships (and S Corps) to file Schedules K-2 and K-3 *unless* you meet exception to filing

a. Why does IRS want foreign info from purely domestic entities?

1) Information needed to help owner compute foreign tax credit (FTC) (if owner paid foreign tax outside boundaries of partnership or S Corp) on Form 1116 (or Form 1118)

b. Why might a wholly domestic (U.S.) partnership be required to file Form 1065 Schedules K-2 and K-3?

1) A partner needs information for computing FTC

2) IRS is making unreasonable demands on filers?

3) Partnership cannot prove it meets a filing exception

4) (1) and (3) above

4. Background of Schedules K-2 and K-3

a. Originally, in July 2021, the IRS introduced Schedules K-2 and K-3 (for Forms 1065, 1120S and 8865)

b. Original K-2 and K-3 Draft Instructions (08/25/21) stated: "Partnerships need *not* complete this schedule if partnership does *not* have items of international tax relevance (typically, international activities or foreign partners)"

1) As a result, tax practitioners initially took this to mean that if a partnership did *not* have international activities or foreign partners, K-2 and K-3 need *not* be filed

c. Changes to K-2 and K-3 Final (01/18/22) **Instructions** significantly added:

1) “A partnership with no foreign source income, no assets generating foreign source income and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3”

2) “For example, if the partner claims a credit for foreign taxes paid by the partner, the partner may need certain info from partnership to complete Form 1116”

3) Now appeared that appeared that preparers of Form 1065 (or 1120S) had to ascertain (i.e., verify) if all partners (or, shareholders) had a need for information (e.g., in order to file Form 1116 or Form 1118), thus making either Schedule K-2 and K-3s required. For those owners that did, then Schedule K-2 and K-3 would have to be supplied. (i.e., “Option #1)

4) Subsequently, it appeared that partnerships need *not* file either Schedule K-2 and K-3 if all partners were contacted and verified (in writing) information *not* needed for partner’s Form 1116 (or 1118)

5) If such verification *not* done, then Schedule K-2 and K-3 had to be completed and given to each owner

d. IRS capitulation and response

1) In response to practitioner and client outcry, the IRS issued FAQs (02/16/22) to provide additional limited (i.e., only for 2021 returns) “transition relief” whereby for domestic (i.e., U.S. activity only) partnerships (and S Corps) to spare them from filing K-2s and K-3s (i.e., “Option #2)

2) Major exception: If the entity did not qualify (i.e., for transition relief under either Option #1 or Option #2), they would still be required to file 2021 Schedule K-2 and K-3

5. IRS position for new Schedules K-2 and K-3

a. Returns filed prior to 2021 had variety of supplemental statements attach to Schedule K-1 attempting to provide information in **“Box 16 - Foreign Transactions”** (and, “Box 20 - Other Information” used for certain international codes) needed regarding either for owner’s filing of Form 1116 (or Form 1118), or other items of international tax relevance.

b. IRS found these “supplemental statements” to be hard to interpret at times, thus causing confusion in determining if entity owners were in compliance when filing their returns

c. New Schedules K-2 and K-3 now provide a “standardized format to provide more clarity for computing U.S. tax” for delivering items of international tax relevance to pass-through owners who need this information in preparing their returns

6. IRS Resources and various helpful informational articles

a. "**Complying With New Schedules K-2 and K-3**," The Tax Advisor, John Samtoy, CPA (02/11/22)

b. Schedules K-2 and K-3 **Frequently Asked Questions** #14 and #15 (Forms 1065, 1120S, and 8865)

c. **Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)**

d. 2021 Partnership **Instructions** for Schedules K-2 and K-3 (Form 1065)

e. **IRS Notice 2021-39**: Transition Period Penalty Relief for New Schedules K-2 and K-3 for Forms 1065, 1120-S and 8865 (06/30/21)

f. **IRS Pub. 514** Foreign Tax Credit for Individuals (For use in preparing 2021 Returns)

g. "So, How Do Foreign Tax Credits Work?", **FixTheTaxTreaty.org**

h. IRS LB&I Practice Unit "Sourcing of Income" **UIL #9432.02-01**

i. IRS LB&I Practice Unit "Overview – Expense Allocation/Apportionment in Calculation of the IRC 904 FTC Limitation" **UIL #9413.03-04**

j. IRS LB&I Practice Unit "FTC General Principles" **UIL #9432.01**

7. AICPA Resources
a. **AICPA letter**: "Additional Comments re: K-2 and K-3" (02/18/22)

B. New Items for 2021 Schedules K-2 and K-3

1. New Form 1065 Schedules K-2 and K-3 *replaces* prior Schedules K and K-1 lines 16 and 20 for certain international codes

Comment: Provides greater clarity for partners to compute U.S. income tax liability re: international tax items, including claiming deductions and credits.

2. Foreign tax credit

a. 2021 Form 1065 Schedule K and K-1, Line 21 replaces 2020 Line 16p for foreign taxes paid (or accrued)

b. Foreign taxes paid (or accrued) must also be reported on:

1) Part III, Section 4, Line 1 of Schedules K-2 and K-3 for foreign tax credit (FTC) purposes

2) Part II, Section 2, Line 45 for foreign taxes *not* creditable, but otherwise

deductible

3. On 01/18/22, the IRS issued "Changes for 2021 Partnership Instructions for Schedules K-2 and K-3"

a. Added to last paragraph in "Who Must File" on page 2: "A partnership with no foreign source income, no assets generating foreign source income, and no foreign taxes paid (or accrued) may still need to report info on Schedules K-2 and K-3

b. Example: If partner claims credit for foreign taxes paid by partner, the partner may need certain information from partnership to complete Form 1116

C. Possible Ramifications for Failure to File Schedule K-2 or K-3

1. Failure to file partnership (**Code §6698**) (or S Corp (**Code §6699**)) return penalty applies either to late, incorrect or incomplete (including failure to attach Schedule K-2 and/or K-3)

2, Penalties for failure to file timely, correct and complete information returns (**Code §6721**) and for failure to file timely, correct and complete payee statements (**Code §6722**) (including Schedule K-2 and/or K-3)

3. May have to supply information to partner who needs it for FTC computation purposes (i.e., if partner needs it for Form 1116 (or 1118))

4. May face **Form 8082** filed by partner (or shareholder) on partner's (shareholder's) return (in response to failure to receive Schedule K-3)

5. Statute of limitations (S/L) on IRS assessment may *not* begin to run on Form 1065 (or Form 1120-S)

Comment: Failure to file an IRS required return/schedule can amount to $210 per month per owner.

D. IRS Notice 2021-39: "Good Faith Effort by Preparers/Clients"

1. IRS Schedule K-2 and K-3 FAQ #10: "Taxpayers who make a good faith effort to comply w/ new K-2 and K-3 for 2021 will *not* be assessed a penalty, per **Notice 2021-39**"

2. IRS will look at following factors:

a. "Made changes to its systems, processes, and procedures for collecting and processing information relevant to filing K-2 and K-3"

b. "Extent to which a Schedule K-2/K-3 filer has obtained information from partners (or S corporation shareholder) or applied reasonable assumptions when information *not* obtained"

c. "Steps taken by K-2/K-3 filer to modify partnership (or S corporation) agreement or governing instrument to facilitate sharing of info w/ partners (and shareholder) relevant to determining whether and how to file K-2 and K-3"

d. "IRS will consider effort made, reasonableness of assumptions and size of partnership (i.e., smaller partnerships less serious) information was *not* obtained from"

3. Example (**FAQ #15**): ABC, LLC is an entirely domestic partnership which has:

a. No foreign owners, no foreign income, no foreign taxes paid;

b. No assets that generate foreign source income;

c. No (or requested) 2020 Form 1065 reporting on Schedule K and K-1 Line 16 and/or Line 20; and

d. No partner has requested information to support the filing of Form 1116 for 2021

e. Result:

1) No K-2, K-3 required for 2021

2) Must document tax file as to how met 2021 transition relief

3) However, Schedule K-2 and K-3 will be required in 2022

E. Reasons to File Schedule K-2 or K-3 Even If Not Required

1. Avoids later obligation to supply information to partner (or shareholder) if so requested

2. Removes need for partners (or shareholders) to file **Form 8082**

3. Earlier adoption to file Schedule K-2 or K-3 in 2021 anticipating no transition relief when all flowthrough entities required to file for 2022 tax year?

F. Partnership Must Supply Information If Requested by Partner

1. FAQ #15: "If a domestic pshp (or S Corp) qualifies for 2021 K-2, K-3 filing relief exception, it need *not* file Schedules K-2 and K-3 w/ IRS or partners (or shareholders)"

2. "However, if partnership (or S corporation) subsequently notified by partner (or shareholder) that all or part of information contained on Schedule K-3 needed to complete their tax return, then partnership (or S corporation) must provide such information to partner (or shareholder)"

G. If Partner Requests K-2/K-3 Information, Must Amended Returns Be Filed?

1. **FAQ #15** states that the answer is "No"

2. Example #1: ABC, LLC is a entirely domestic entity taxed as a partnership that meets the above-mentioned four requirements for "transition relief" pursuant to IRS **Notice 2021-39**. As a result, it is exempt from filing Schedules K-2 or K-3.

a. However, after its Form 1065 is filed, a member (i.e., partner) requests information that would have otherwise been reported on Schedule K-3.

b. No amended Form 1065 is specifically required, but the partnership is required to supply the needed information to that member.

Comment: If such a request is made before the return is filed (i.e., either Form 1065 or Form 1120S), then the information must be provided, but also, Schedule K-2 and K-3 need to be included when the return is ultimately filed.

H. Form 8082 - Notice of Inconsistent Treatment (FAQ #16)

1. **Instructions** for **Form 8082**, page 1: "Use Form 8082 to notify IRS if you did *not* receive Schedule K-1 by the due date for filing your return (including extensions)", or

2. "If you believe that you should have received K-3 but did not, use **Form 8082** to notify the IRS"

3. "The IRS will publicly release a *new* cover sheet for **Form 8082** in near future containing similar guidance"

I. Mechanics and Timing for Filing Schedule K-2 and K-3

1. Form 1065 - March 20, 2022

2. Form 1120S - Mid-June, 2022

3. IRS **FAQ #7**: May be filed as .PDF attachment at any time on e-filed (Forms 1065, 1120-S or 8865) return

Comment: Some tax prep software automatically attaches the .PDF copy, while others require the preparer to manually attach Schedule K-2 and K-3.

J. Practical Considerations Regarding Filing Schedule K-2 and K-3

1. Given the learning curve with the new Schedule K-2 and K-3 (or, proving "transition relief", many practitioners filed extensions for Form 1065 or Form 1120S

2. Preparers should make sure that all partners properly documented (i.e., w/ **Form W-8** for foreign partners) or **Form W-9** (i.e., for U.S. partners) in order to avoid tax back-up withholding obligations or related problems.

3. As stated previously, if Schedule K-2 or K-3 are *not* filed when required, then the statute of limitations (S/L) on IRS assessment may *not* begin to run.

☞**Clarifications for Disregarded Entities and Section 743(b) Reporting**

The IRS issued **Frequently Asked Questions** (FAQs) related to **Part II, "Information About the Partner"** section on **Form 1065** clarifying "disregarded entity reporting." The three FAQs address beneficial ownership, tiered disregarded entity ownership, and grantor trust ownership. In addition, the IRS FAQs include three examples that illustrate how a partnership should report **Code §743(b)** adjustments for purposes of **Line 11 (Other income)** and **Line 13 (Other deductions)** of **Form 1065**. Two additional examples illustrate what should be reported on **Line 20**, using **Code AH (Other information)** relating to **Code §743(b)** adjustments. **(Misc.; Form 1065)**

Comment: These requirements continue to apply for the 2023 tax year returns.

☞**Revocable Trusts & Electing Out of Partnership Audit Rules**

The owners of the partnership are a S-Corp and a revocable trust in the name of the wife. The S-Corp is owned by a revocable trust in the husband's name. Does having a partner that is a "revocable trust" prevent the option to elect out of the partnership audit rules? Two recent articles discuss this issue.

According to a **Tax Advisor** article, "The IRS decided *not* to expand the definition of "eligible partner" to include persons or entities other than those in the statute even though it has received numerous comments requesting it to exercise its discretionary authority to do so. As a result, an "eligible partner" for purpose of electing out of the new partnership "centralized audit rules" does *not* include partnerships, trusts, disregarded entities, nominees, or other similar persons that hold an interest on behalf of another person, foreign entities that are *not* eligible foreign entities, and estates that are *not* estates of a deceased partner."

On the other hand, the **Kiplinger Tax Newsletter** states "Note that a partnership interest held 'in trust' is generally *not* eligible to elect out of the rules. While no direct statutory authority exists to evidence an exception for *revocable* trusts, they are typically viewed as 'disregarded entities' for tax purposes. We suspect that this would permit an election out for a partnership interest held in a revocable trust. However, we do *not* yet have a guidance from the IRS on this issue." **(Misc.; IRS Audits)**

Comment: At this point, a good argument can be made that revocable trusts (that do *not* "spring into being" until the death of the grantor) are indeed "disregarded entities" for income tax purposes under **Code §671**. Therefore, an election should be allowed to opt out of these new partnership audit rules since the partnership (and, S corporation) interests in this case are deemed owned by the respective husband and wife grantors for income tax purposes of the Code.

Code §1(h) - Unrecaptured Sec. 1250 Gain:

☞**Unrecaptured §1250 Gain Treatment Avoided on Liquidating Distributions Made Out of Real Estate LLCs**

Consider a situation where a member of an LLC holding appreciated real estate decides to sell out their interest to an unrelated third party. To the extent that there is any gain due to straight-line depreciation, this will be considered "unrecaptured Sec. 1250 gain" which is taxed at no more than a 25% marginal tax rate. And, this gain, along with any other Sec. 1231 gain on the property, would flow from Form 4797 to Schedule D. Basically, the rule is that the normal capital gains treatment accorded by **Code §741** is negated by the "hot asset" rules of **Code §751**. Surprisingly, there is a different answer where this partner or LLC member has their interest terminated by receiving a liquidating distribution from the entity itself (i.e., similar to a stock redemption had this instead involved a corporation). **Reg.§1.1(h)-1(b)**, (which deals with the appropriate tax rates in various situations) indicates that the 25% rate does *not* come into play, as well as the **Code §751** "hot asset" rules *not* being imposed, where the interest is *redeemed* instead of being sold to an outside third party. As a result, the exiting partner receives Sec. 1231 treatment on the *entire* gain, and absent any Sec. 1231 losses for the current year (or prior 5 years that have *not* otherwise been recaptured), this entire gain would flow to Schedule D. **(Code §1(h); Unrecaptured Sec. 1250 Gain)**

Comment: If the real estate market was depressed in some areas of the country, it might not be unusual to see LLC members wanting to perhaps cash out of their ownership interests. By having the entity refinance their real estate holdings and redeem this member's interest, they will be able to exit with capital gains treatment (which could be taxed at up to 23.8% vs. certain unrecaptured Sec. 1250 gain being taxed at up to 25%). Of course, the remaining members of the LLC would then be stuck with this exiting member's share of 25% gain when they sold their respective interests (or, just had the entity sell the property with the proceeds being passed out on the dissolution of the entity).

Code §111 - Tax Benefit Rule:

☞**IRS Issues Guidance on State Tax Payments and Refunds (IR-2023-158)**

The Service has provided guidance on the federal income tax status with regard to refunds of state or local taxes, as well as certain other payments made by state or local governments to individuals. The guidance is part of the IRS's efforts "to provide additional certainty to states and their residents regarding the federal income tax consequences of state payments made to taxpayers."

> **Comment:** The IRS previously provided guidance on state payments made in 2022 in news release **IR-2023-23**.

In 2022, a number of states implemented programs to provide payments to certain individuals residing in their states. Many of these programs were related, directly or indirectly, to the various consequences of the Coronavirus Disease 2019 (COVID-19) pandemic, and the programs varied in terms of the types of payments, payment amounts and eligibility criteria. **IR-2023-23** addressed the federal tax treatment of these 2022 payments.

Notice 2023-56 describes certain types of state payments to individuals and the federal tax treatment of those payments. This new IRS release updates the previous guidance, which only described the taxability of payments made during 2022.

Most taxpayers receiving state tax refunds do *not* have to include the state tax refund in income for federal tax purposes, given that they have chosen to use the standard deduction on their federal income tax returns. Approximately, 93% of taxpayers claim the standard deduction.

On the other hand, taxpayers who itemize their deductions on their federal income tax returns and receive a state tax refund must include the refund in income only if they deducted the state tax paid. Because of the $10,000 limit on itemized deductions for state income and property taxes, some itemizers are *not* able to deduct all of the state taxes they paid and do *not* need to include a refund in income.

> **Comment:** Unlike prior guidance, the IRS "got it right" this time around (i.e., pursuant to the "tax benefit rules" contained in **Code §111**). For instance, if the taxpayer's $10,000 itemized deduction limit for state or local taxes comes solely from real estate, personal property and/or sales tax, and *not* at all from income taxes (i.e., they are *not* even listed on **Schedule A**), then any refund of state or local income taxes previously paid should *not* have to be included in gross income.

Spillover Payments Received in 2023: Some of the 2022 programs covered in this new IRS guidance include certain state payments under the program to be made in early 2023. To the extent that the news release provided that taxpayers could exclude the state payment received in 2022 from federal income, this treatment will also apply in 2023.In other words, taxpayers who did *not* get a payment under the program during 2022 may exclude from federal income a state payment provided under the 2022 program but actually received in 2023.

State General Welfare Programs: Payments made by states under "legislatively provided social benefit programs for the promotion of the general welfare" are also *not* included as income on an individual recipient's federal income tax return. To qualify for the "general welfare exclusion," state payments must be paid from a governmental fund, be for the "promotion of general welfare" (i.e., based on the need of the individual or family receiving such payments), and *not* represent compensation for services. **(Code §111; Tax Refunds)**

Comment: As the IRS notes in this news release, determining whether payments qualify for this "general welfare exclusion" is a complex, fact-intensive inquiry that depends on a number of considerations. **Notice 2023-56** provides an example of a general welfare situation.

Code §162 - Trade or Business Expenses:

☞**Otherwise Reimbursable Expenses Not Deductible by Partner on Schedule E (*McLauchlan v. Commr.*, 113 AFTR 2d 2014-XXXX (5th Cir., 3/6/2014))**

The 5th Circuit confirmed that a law firm partner should *not* be permitted to deduct business expenses that were otherwise reimbursable by the firm. The partnership agreement specifically stated that expenses incurred for "business meals, automobiles, travel and entertainment, conventions, continuing legal education seminars and professional organizations" would be borne by the partner unless reimbursement was approved by the managing partner. Additional expenses that taxpayer "chose to incur," such as for advertising, home office, or supplies, were *not* deductible as "partnership expenses." Because all of the claimed expenses in this instance were potentially reimbursable by the partnership, or were *not* partnership expenses that taxpayer was required to incur, the 5th Circuit *affirmed* the Tax Court's disallowance. To conclude otherwise "would allow a taxpayer to convert an expense of the partnership into one of his own simply by failing to seek reimbursement." **(Code §162; Partnership Expenses)**

Code §163 - Investment Interest Expense:

☞**Inherited Partnership Interests Not Subject to Investment Interest Limit (*Lipnick*, 153 TC No. 1 (8/28/2019))**

The taxpayer acquired interests in four partnerships by gift or bequest from his father. Prior to the transfers, the father received debt-financed distributions from the partnerships. After receiving the interests, the taxpayer treated his distributive shares of partnership interest expense as fully deductible against his allocations of partnership income. The IRS argued that the taxpayer should have "stepped into the shoes" of his father and reported the expense on **Form 4952** as "investment interest" subject to the **Code §163(d)** limit. The Tax Court disagreed, holding that the taxpayer made a "debt-financed acquisition of the partnership interests" (i.e., governed by IRS **Notice 89-35**) he received from his father. Because the taxpayer did *not* actually receive the proceeds of the partnerships' debts, interest expense passed through to him was *not* "investment interest" under **Code §163(d)**

Background - Investment Interest: In the case of a taxpayer other than a corporation, the amount allowed as a deduction for investment interest for any taxable year cannot exceed the "net investment income" (i.e., for **Form 4952** purposes as opposed to NIIT which is used for **Form 8960** purposes with the 3.8% Medicare surtax) of the taxpayer for the taxable year. (**Code §163(d)(1)**). "Investment interest" is defined as interest that is "paid or accrued on indebtedness properly allocable to property held for investment." (**Code §163(d)(3)(A)**)

Background - Interest Expense "Tracing Rules:" Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. (**Reg. §1.163-8T(a)(3)**) For example, if a taxpayer uses debt proceeds to make a personal expenditure, such as taking a vacation, the interest is treated as nondeductible personal interest. (**Reg. §1.163-8T(a)(4)(ii), Example (1)**)

These regs, however, do *not* specify how these tracing rules apply to partnerships and their partners. But the IRS has published guidance in **Notice 89-35**. That Notice states that, if a partnership uses debt proceeds to fund a distribution to partners (i.e., to make debt-financed distributions), it is each partner's actual use of the proceeds to determine whether the interest passed through to them constitutes investment interest. As a result, if a partner uses the proceeds of a debt-financed distribution to acquire property that he holds for investment, the corresponding interest expense incurred by the partnership and passed on to them will be treated as investment interest.

On the other hand, **Reg. §1.163-8T(c)(3)(ii)** explains how debt should be allocated where *no proceeds are actually disbursed* to the taxpayer. It states that if a taxpayer incurs or assumes a debt in consideration for the sale or use of property or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property.

Notice 89-35 in **Part IV.** refers to the scenario described in **Reg. §1.163-8T(c)(3)(ii)** as a "debt-financed acquisition," as opposed to a "debt-financed distribution," and it explains how the reg applies to partnerships and their partners: "In the case of debt proceeds allocated under **Reg. §1.163-8T** to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method."

Facts: The taxpayer's father had owned interests in partnerships that made "debt-financed distributions" to the partners and he had used the proceeds of those distributions to purchase assets that he held for investment. As a result, he treated the interest paid by the partnerships on those debts and passed through to him as "investment interest" (i.e., on **Form 4952**) subject to the limitation on deductibility imposed by **Code §163(d)**. But, the taxpayer in this instance who inherited (or, was gifted) these partnership interests was *not* personally liable for any of the partnership loans. And, the partnerships continued to incur interest expense on the debts, which was passed through to the taxpayer as a *new* partner which he treated as allocable to the partnerships' real estate assets and reported the interest expense (i.e., on **Schedule E, page 2**) as regular business interest that offset the passed-through partnership real estate income.

Tax Court Decision: The Court characterized the IRS's argument as essentially being that the taxpayer "stepped into his father's shoes," with the result that the interest should be reported as "investment interest," and would remained as such so long as the loans remain on the partnerships' books. The Court, however, found that there was no support for this theory in the statute, the regs, or the decided cases, especially since the taxpayer *did not receive, directly or indirectly, any portion of the debt-financed distributions* that the partnerships made to his father. Nor did the taxpayer use distributions from those partnerships to make investment expenditures.

Instead, the Court concluded that, whereas the father received a "debt-financed distribution," his son (i.e., the taxpayer in this case) should be treated as having made a "debt-financed acquisition" of the partnership interests he acquired from his father by way of gift or inheritance. Therefore, for **Code §163(d)** purposes, the debt proceeds should be allocated among all of the partnerships' real estate assets using a reasonable method, and the interest paid on the debt is allocated to those assets in the same way. (**Reg. §1.163-8T(c)(1)**) In this instance, the partnerships' real estate assets were actively managed operating assets. Even the IRS agreed that those assets did *not* constitute "property held for investment."

The IRS countered that under **Reg. §1.163-8T(c)(3)(ii)**, the taxpayer, when acquiring the partnership interests from his father, did *not* "assume a debt" or "take property subject to a debt." Instead, these loans "were bona fide liabilities of the partnerships." As a result, the taxpayer had no personal liability on those loans, which were nonrecourse, and that the liens held by the lenders ran against the partnerships' real estate assets, *not* against the taxpayer's partnership interests.

The Court disagreed stating that the taxpayer acquired his interests in the partnerships subject to the partnership debts, even though he did *not* personally assume those debts, which remained nonrecourse with respect to the partners individually. In the converse situation, where a partner sells a partnership interest, the regs provide that the partner's "amount realized" includes his share of the partnership liabilities of which he is relieved, even if the liabilities are nonrecourse. (**Reg. §1.752-1, Reg. §1.1001-2(a)(4)(v)**) For purposes of subchapter K partnership rules generally, any increase or decrease in a partner's share of partnership liabilities is treated as a deemed contribution or distribution, regardless of whether the debt is recourse or nonrecourse. (**Code §752; Reg. §1.752-1**). And, the fact that a partner is *not* personally liable for a partnership's debt does *not* mean that his partnership interest is *not* "subject to a debt" for purposes of Subchapter K. The Court then concluded that **Reg. §1.163-8T(c)(3)(ii)**, in conjunction with **Notice 89-35**, dictates that the interest expense passed through to the taxpayer from the partnerships was *not* "investment interest" under **Code §163(d)**. **(Code §163; Investment Interest)**

Code §165 - Losses:

☞**Bad Debt Deduction for Related Party Loan Denied (*Keeton*, TC Memo. 2023-35 (3/16/2023))**

The IRS will pay close attention to the deduction of bad-debt losses stemming from related-party transactions. In this instance, a partnership that was owned by two couples made cash advances over a period of years to a company with essentially the same owners. Eventually, when these advances were *not* repaid, the partnership claimed a sizable bad-debt deduction, passing it through to the taxpayers on their K-1s. Upon review by the Tax Court, it stood behind the Service's treatment of these advances as nothing more than deemed capital contributions to the other related company (i.e., using the partnership as a conduit). Some of the key factors in determining that the advances were *not* bona fide debts were that the debtor corporation was "thinly capitalized" (i.e., so that it was very unlikely that other unrelated third-party lenders would have made such loans) and that the owners of the creditor and debtor had complete control of both entities meaning that the creditor had no right to enforce payment of the debt. Also, there was no fixed maturity date and the creditor failed to regularly pay any interest. Finally, even though there was eventually a written note, the Court gave that little credibility, in part because of the relationship between the parties. **(Code §165; Bad Debt Deduction)**

> **Comment:** Even though this "bad debt deduction" was disallowed, the advances would most probably be viewed as additional capital contributions being made by the individual partners when they caused their partnership to forward the funds that it had on-hand to this commonly-controlled company on their behalf. As a result, the basis that they had for their investment in the company would be correspondingly increased. So, if or when the company went under, or the partners sold their investment therein, it would result in a capital loss which is *not* much different than a STCL if "non-business bad debt" treatment had been allowed. In other words, it simply comes down to a matter of "timing" with regard to this write-off.

Code §702 - Partner's Distributive Share:

☞**Partner Taxed on Distributive Share Regardless of Being Constructively Received (*Dodd*, TC Memo 2021-118 (10/5/2021))**

The Tax Court agreed with the IRS that a partner was liable for tax on her distributive share of income from the partnership, regardless of whether she constructively received that allocable share of income or not.

Background: **Code §702(a)** provides that, "[i]n determining his income tax, each partner shall take into account separately his distributive share" of the partnership's items of income and loss. Specifically, each partner must include their distributive share of the partnership's "gains and losses from sales or exchanges of property described in section 1231." (**Code §702(a)(3)**) This rule applies regardless of whether the partner receives the income currently, via distribution or otherwise. (***Basye*, 31 410 U.S. 441 (S Ct, 12/271973)**)

Facts: In 2013, a partnership in which the taxpayer was a partner sold a building. The partnership then sent her a K-1 allocating $1 million as a net section 1231 gain for the year. Also in 2013, the partnership paid back a loan it had taken out in 2011 (i.e., repayment of principal on a loan does *not* give rise to a tax deduction). The taxpayer was a co-borrower on the loan. The amount of the share of Dodd's loan liability that was paid back was more than $1 million. The taxpayer did *not* pay income tax on the 1231 gain, arguing that she never received the money because it was used to pay back the loan. In other words, she did *not* constructively receive the funds under **Reg §1.451-2**.

Tax Court Decision: The Tax Court disagreed with the taxpayer and concluded that for Federal tax purposes the question is *not* whether she constructively received the funds. Under **Code §702(a)**, the Court agreed that she is taxable on her distributive share of the section 1231 gain whether or not it was actually distributed. **(Code §702; Distributive Share)**

> **Comment:** Here, the monies derived from the sale of the real estate were used to make a distribution to the majority partner (i.e., who controlled the "purse strings" of the entity). So, the taxpayer here had to pay tax on the $1 million Sec. 1231 gain allocated to her despite not have any cashflow from the partnership to do so. The "moral of the story" is that if you are going to be a minority owner in a flowthrough entity (i.e., S corp or partnership/LLC), make sure that there is a written clause in your ownership agreement that distributions sufficient to pay all federal, state and local taxes will be made each year to you.

Code §704 - Partner's Basis in Capital Account:

☞**New IRS Audit Effort Focuses on Partnership Loss Limitation Rules**

The IRS Large Business and International (LB&I) Division recently announced that it has added a new "**compliance campaign**" which addresses the tax basis limitations that apply to the amount of partnership losses (or, deductions such as Sec. 179 immediate expensing) that can be claimed by its partners. The **Code §704(d)** limitations which "are the main focus of this campaign" state that a partner's distributive share of partnership loss will be allowed only to the extent of the partner's adjusted basis in his partnership interest at the end of the partnership year in which the loss occurred. If the partner's share of losses exceeds this amount, the excess amount is suspended and may be carried over for use in another tax year in which the partner has basis available. The IRS has said that "partnership compliance is a priority and that the agency is stepping up enforcement." **(Code §704; K-1 Losses)**

Comment: Starting with the 2022 tax year, there are basically four distinct barriers to taking a flowthrough loss from a partnership return. They are applied in the following order: (1) Adjusted basis of the partner's interest; (2) How much of that adjusted basis is considered to be at-risk (i.e., pursuant to **Code §465** as shown on **Form 6198**); (3) Is the loss (or, deduction such as Sec. 179 immediate expensing) subject to the passive loss (PAL) rules under **Code §469**, and (4) Does the loss represent an "excess business deduction" under **Code §461(l)** $250,000/500,000 limits. If a capital loss is being passed through on the K-1, then it might also be subject to the overall cap of $3,000 annually. And, any NOLs which might result due to a K-1 loss can only be carried forward starting in 2021 onward.

Comment: The S corporation equivalent of this increased focus by the IRS on properly claiming K-1 losses or deductions flowing through from a partnership, is the current requirement on page two of **Schedule E, Part II** where a separate "basis statement" (i.e., on **Form 7203**) needs to be provided if (1) a K-1 loss is being claimed; (2) the shareholder is receiving a distribution; (3) the shareholder is disposing of their stock; or (4) the shareholder is receiving a loan repayment from the S corporation. **(Code §704; Partnership Losses)**

☞**Recent Case Highlights Inappropriate Claiming of Partnership Losses** (***Kohout*, TC Memo. 2022-37 (4/18/2022)**)

An individual owned 1% of a partnership with the other 99% being owned by an S corporation, which was wholly owned by the same individual. The partnership incurred $132,000 in losses for the year, and this individual partner claimed that both he and the S corporation should be allowed to deduct their pro rata share of the partnership's losses. But because neither he nor the S corporation could prove their adjusted basis in their partnership interests, the Tax Court agreed with the IRS and disallowed the pass-through losses.

Partner's Adjusted Basis in Partnership Interest: Generally, under **Code §704(d)**, a partner is permitted to deduct their share of a partnership's loss for a taxable year only to the extent of the adjusted basis of their partnership interest calculated as of the end of the tax year. Under **Code §§705(a)(1)** and **722**, a partner's "outside basis" is *increased* in part by the partner's distributive share of income and the partner's contributions to the partnership. Meanwhile, under **Code §752(a)**, any increase in a partner's share of liabilities or assumption of partnership liabilities also increases the partner's outside basis. On the other hand, under **Code §§705(a)(2)** and **733**, a partner's basis is then *decreased* by the partner's distributive share of partnership losses, nondeductible expenses, and distributions.

Deducting K-1 Losses: If the partner cannot establish their adjusted basis in their partnership interest, then they are barred from currently deducting any partnership losses. (See **Code §704(d)**; ***Sennett v. Commr.*, 80 T.C. 825, 829–30 (1983), *aff'd*, 752 F.2d 428 (9th Cir., 1985)**. Furthermore, "proof of basis is a specific fact which the taxpayer has the burden of proving." (See ***O'Neill v. Commr.*, 271 F.2d 44, 50 (9th Cir. 1959), *aff'g* T.C. Memo. 1957-193**; see also ***Powers v. Commr.*, T.C. Memo. 2013-134**) **(Code §704(d); K-1 Losses)**

Note: The following items are taken from the "2022 Partnership/LLC Taxation Guide" . . .

☞**At-Risk and Passive Loss Rules:** While a member's **outside basis** is an important factor to consider when determining the K-1 loss a taxpayer may deduct, or to determine whether a distribution is in excess of basis, there are **two other equally important factors**:

- At-risk limitations

- Passive loss limitations

<u>Comment</u>: Although delayed from the original TCJA 1/1/2018 date, the Code §461(l) "excess business deduction" limitation (discussed below) will now be effective beginning in the 2021 tax year and it represents the "4th barrier" in being able to take a K-1 loss/deduction (i.e., after the basis, at-risk rules and passive loss limitations are first applied).

Basis, at-risk limitations, and passive loss limitations **can all result in suspended losses**. A major difference is that **suspended <u>basis</u> losses cannot be used to reduce gain upon liquidation or disposition of the partnership interest**. As a result, steps should be taken to **increase one's basis before disposition** so that these particular suspended losses can be utilized. Furthermore, these losses also **remain personal** to the selling partner so that they **cannot benefit** the new owner. But, at least suspended **at-risk** and **passive losses** can be used to **reduce gain** upon liquidation or disposition of the partnership interest. To avoid confusion, it is important to remember that the **tax basis** of a partnership interest is normally ***not*** the same as the **capital account**. One important difference is that an owner's capital account does **not** change when the total liabilities of the entity varies.

☞**Code §465 - At-Risk Rules:** Even if a partner has sufficient **basis** to initially absorb all the loss flowing through on his Schedule K-1, the **Code §465** at-risk limitations can still affect the limit on any deduction. The at-risk rules serve to limit a taxpayer's loss deduction to the amount he **could actually lose** from the activity.

The at-risk rules generally limit deductions to amounts for which the taxpayer has **a risk of economic loss**. Amounts disallowed under the at-risk rules retain their character and carry over indefinitely, and become allowable when the taxpayer has sufficient at-risk basis.

<u>Comment</u>: The at-risk rules apply *after* the initial basis limitations, and *before* the passive activities rules under **<u>Code §469</u>**. Computations are made on **Form 6198**. At-risk basis for an owner is generally determined as of the close of the taxpayer's year.

The at-risk rules apply to individuals, estates, trusts and closely-held corporations, including PSCs and S corporations. With partnerships and LLCs, the at-risk rules apply to activities conducted by the entity, but at the partner or member level. As a result, it is possible for some partners to be at-risk while others are not.

<u>Comment</u>: The **Code §465** at-risk rules apply first at the corporate level and then to the shareholders in cases involving S corporations. And, if the corporation is *not* at risk, none of the shareholders are. The only exception is for "direct shareholder loans" made

Generally speaking, the amounts at risk are listed **Code 465(b)** and include:

- Money and the basis of other property contributed for use in the activity;

- Debt for which the taxpayer is personally liable (i.e., as a guarantor);

• Qualified nonrecourse real property indebtedness (i.e., **Code §465(b)(6)**);

• The FMV (not basis) of property *not* used in the activity that the taxpayer has pledged as security for loans used in the activity; and

• Income from the activity that the taxpayer has *not* withdrawn.

Comment: At-risk amounts also include personal loans made by a partner (or, S corp shareholder) directly to the entity.

With regard to the loans of the entity, debt for which the taxpayer is personally liable generally is treated as an amount at risk. However, the taxpayer is *not* at risk with respect to amounts protected against loss (e.g., nonrecourse financing, guarantees, stop loss agreements, or similar arrangements). Nevertheless, for purposes of the at-risk rules, insurance coverage is *not* treated as protection against loss.

One of the major differences between a partnership v. an S corp has to do with how loan guarantees are treated for tax basis, as well as the at-risk rules. For S corporations, a loan guarantee generally does *not* increase the taxpayer's amount at risk, unless and until the taxpayer actually pays the debt and has no remaining legal rights against the primary obligor. However, a partner or member that guarantees the partnership's or LLC's debt generally is at risk except to the extent that the member has a right of recovery (i.e., subrogation rights) from other members.

Essentially, the at-risk rules affect that portion of a partner's basis which is derived from the **sharing of allocable partnership liabilities** if the particular partner is **not** at risk for that debt amount. For these purposes, the guarantee of a debt puts the guarantor partner at risk **since he bears the burden** of repaying the debt if the partnership defaults. However, for any other **nonrecourse** debt, except for "qualified real property indebtedness," this amount is then subtracted from the initial basis amount (i.e., since it is **not** considered to be at risk).

To reiterate, a partner's amount considered at risk includes all cash invested in the partnership, the adjusted tax basis of all property contributed, and most borrowed amounts for which the taxpayer personally bears the economic risk of loss for its repayment if the partnership defaults (i.e., "hard basis"). One can argue that a taxpayer's amount at risk in an investment is essentially equivalent to his adjusted tax basis in the property with one major difference. Generally, nonrecourse loans used to increase a partner's basis do *not* increase a taxpayer's amount considered at risk. However, amounts borrowed from any person having an interest in the activity (other than an interest as a creditor), i.e., a "prohibited continuing interest," are *not* considered to be at risk. (**Code §465(b)(3)**)

Under **Reg. § 1.465-8(b)(1)**, a person has a "prohibited continuing interest" under **Code §465(b)(3)** only if the person has either a capital interest in the activity or an interest in the net profits of the activity. A "capital interest" is defined as an interest in the assets of the activity which is distributable to the owner of the capital interest upon the liquidation of the activity. (**Reg. § 1.465-8(b)(2)**) A person may have an interest in the net profits of an activity even though he or she does *not* possess any incidents of ownership in the activity. (**Reg. §1.465-8(b)(3)**) **Code §465(b)(3)** focus on a "prohibited continuing interest" is most concerned with any "fixed and definite rights or interests that realistically may cause creditors to act contrary to how independent creditors would act with respect to their rights under the debt obligations in question."

The **Code §465** at-risk rules were introduced by the **1976 Tax Act** in response to the **rampant use of**

nonrecourse debt in tax shelters. Significant tax basis was generated by such debts under **Code §752(a)**, thus permitting the deduction of K-1 losses **far in excess of any capital contributions** by the partners. Yet, there was little chance that any of these partners, especially limited partners, would ever be called upon to repay these debts.

> **Comment:** Since only **direct shareholder loans** serve to increase basis in an S corporation, and the particular shareholder that loaned the money is at-risk for these funds, the **Code §465** at-risk rules **rarely come into play** to decrease the initial debt basis calculation for a shareholder.

There is an exception for "qualified real property indebtedness." As mentioned above, taxpayers are **not** considered at risk for amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements.[1] As a result, when there is no realistic possibility of personal economic loss by a particular owner, deductions are disallowed.[2]

This exception was lobbied for and eliminated from these at-risk rules in the **1984 Tax Act**. The banking and real estate lobbyists successfully argued that nonrecourse debt, secured solely by real estate and made by a qualified financial institution, as opposed to a marketer or promoter of the tax shelter is still considered at risk **even though it is unlikely** that any of the owners will ever be called upon to repay the debt.

Example 1: "At-Risk Rules and Nonrecourse Debt on Other-Than-Real Property Indebtedness"

The partnership borrows $100,000 from a local bank. The nonrecourse debt is only secured by the equipment purchased with the borrowed funds (i.e., a chattel mortgage). The individual partners' basis is initially increased by a corresponding amount.[3] However, under the **Code §465** at-risk rules, this basis is reduced by the same amount.

Example 2: "At-Risk Rules and Qualified Real Property Indebtedness"

Use the same facts as **Example 1**, except the $100,000 is used as a down payment on the purchase of real estate, which is the sole source of security for the nonrecourse debt. Because of the exception created under **Code §465** related to "qualified real property indebtedness," the basis increase created by **Code §752(a)** is **not** reduced by the at-risk rules, even though this is a **nonrecourse** debt.

Losses disallowed under the at-risk rules remain suspended until the taxpayer's at-risk investment in the activity increases (e.g., he personally guarantees a debt or "qualified real property indebtedness" otherwise increases) or income from the activity (i.e., "positive" K-1 items) is includible in the partner's basis.[4] Normally, this occurs no later than when the taxpayer ultimately disposes of his partnership interest in a taxable transaction.

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[1] IRC §465(b)(4)

[2] *Whitmire v. Commr.*, 109 TC 266 (1997), aff'd, 178 F.3d 1050 (9th Cir. 1999).

[3] IRC §752(a)

[4] IRC §465(a)(2)

Under the "qualified real property indebtedness" exception, taxpayers are considered at risk for their proportionate share of qualified nonrecourse financing.[5]

Qualified nonrecourse financing is:

- Any debt incurred in connection with the activity of holding real property,

- Which is borrowed from or guaranteed by, any federal, state or local government, or which is borrowed from a qualified person who is actively and regularly engaged in the business of lending money;

- The real property in question must be the sole source of collateral for the debt, with none of the entity's members being personally liable for its repayment and

- The financing cannot be convertible from a debt obligation to an ownership interest.

A "qualified person" is:

- Regularly engaged in lending money;

- Not related to the taxpayer;

- Not receiving a fee in connection with the taxpayer's investment in the property; and

- Not the person from whom the taxpayer acquired the property.

Under final Treasury regulations issued in August 1998, the liability of the LLC for the indebtedness is ignored for purposes of the at-risk rules.[6] In other words, if the financing is deemed to be "qualified nonrecourse financing," the members or partners share it, and they are deemed to be at risk to the same extent that they share the liability under the normal rules of **Code §752**.

☞**Code §465(e) - Recapture of amounts previously at-risk:** If a combination of losses, withdrawals and/or conversion of at-risk amounts to amounts *not* at-risk would otherwise take a taxpayer's amount at risk below zero, the taxpayer has income equal to the *lesser* of: (1) What the negative at-risk amount would have been, or (2) Previously deducted net losses from the activity.

> **Comment:** One of the most common causes of recapture of at-risk amounts is when a particular debt that was recourse as to one or more owners now becomes nonrecourse, or a recourse debt is now shared differently than when a K-1 loss was taken in a prior tax year (i.e., with this specific owner now sharing in less, or none, of the debt that was converted). Or, simply the principal balance outstanding on the guaranteed debt is paid down.
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> **Comment:** If a taxpayer has a negative at-risk amount, it carries over, and the taxpayer must become at risk in order to eliminate the negative amount *before* any subsequent loss

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[5] IRC §465(b)(6)

[6] Treas. Reg. §1.465.27

passthroughs are allowed.

☞**Code §465(e) - Recapture of Previously Recognized Losses:** In certain situations, the recapture of previously recognized losses may be required. Frequent reasons for recapture are a change in the character of partnership debt or a reduction in the amount of debt. If a recourse debt is converted to a nonrecourse debt, the conversion will affect the at-risk basis calculation for the partners, both directly by the characterization shift (non-recourse debt does *not* provide at-risk basis) and indirectly by its effect on debt allocation. This can result in unwanted consequences. At-risk recapture can also occur when the partnership makes distributions to the partners, reducing their amount at risk (**Prop. Regs. §1.465-22**). It is important to note that if a partnership has had income in excess of deductions throughout its existence (and, therefore, has never had a **Code §465(d)** loss), there would be no recapture even if a partnership distribution reduces the at-risk basis below zero, because the taxpayer has no prior loss to recapture (**Code §465(e)(2)**).

Example: "At-risk Recapture Not Required for Profitable Partnership"
ABC Partnership began operation in 20x1, has reported income in excess of deductions for 20x1, 20x2, and 20x3, and at the end of 20x3 has nonrecourse debt secured by transportation equipment. At the end of 20x3, Partner B has an at-risk basis composed of a cash contribution of $50,000 and three years of his share of earnings totaling $10,000, for a total at-risk basis of $60,000, and a tax basis of $80,000 (including nonrecourse debt of $20,000). If the partnership distributes $70,000 to Partner B, the at-risk basis is reduced to ($10,000), while his tax basis is reduced to $10,000. Partner B has no Sec. 465(e) recapture because there have been no previously allocated losses.

☞**At-Risk Recapture - When Previous Sharing of Partnership Liabilities Shifts to Other Owners**

1. It is entirely proper for a guarantor of a partnership debt to use their respective share as additional "soft basis" in order to take any losses allocated to them via their K-1

   a. But, if that share of the debt is shifted onto some of the other partners (or, to new partners) in a subsequent tax year, or that partner ceases being a guarantor, it could result in the recognition of income under the **Code §465(e)** "at-risk recapture rules."

Example 5: "Income Inclusion Due to At-Risk Recapture Rules"

An LLC has three equal members, A, B and C who each make a $10,000 contribution to capital for their partnership interest. The entity has a $100,000 line of credit, but only A agrees to guarantee the debt. During the first year, the entity has a $130,000 ordinary trade or business loss (i.e., as shown in Box 1 of their K-1s) which is initially allocated $10,000 to each of the members. The remaining $100,000 of the loss is then specially allocated[7] to A since he was the sole guarantor of the line-of-credit debt which was used to finance the majority of expenses incurred for that first tax year.

In year two, however, when the LLC otherwise had -0- income or loss from operations, the lender insisted (in order to have more security on the line-of-credit debt) that B and C also join A as

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[7] Code §704(b)(2)

guarantors on this LLC liability. What impact, if any, would this have on A?

Under **Code §465(e)**, A would now only share in 1/3 of the $100,000 debt for at-risk basis purposes. As a result, A would now have to include as ordinary income (i.e., on page 2 of Schedule E, either as passive or nonpassive income, depending on whether he is materially participating in the LLC), $67,667.

<u>Example 6</u>: Same facts as in **Example 2** above, except A, B and C were all co-guarantors of the $100,000 line of credit in year one. As a result, each member was allocated 1/3 of the $130,000 loss (i.e., $10,000 due to their "hard basis" and $33,000 additionally due to their "soft basis" stemming from their respective guarantees).

In the second year, two new members (D & E) were admitted to the partnership so that the entity was now owned equally by these five members. In addition, these two new members also agreed to be co-guarantors on this $100,000 liability. Once again, the LLC had -0- income or loss from operations. What impact, if any, would the admission of D and E to the LLC, and their agreeing to be co-guarantors on the debt, have from a tax standpoint?

As in the case of **Example 2** above, **Code §465(e)** at-risk recapture rules would cause A, B and C to now include $13,334 (i.e., $33,334 - 20,000) of ordinary income on page 2 of Schedule E due to the decrease in the amount of the debt that they were now considered to be at-risk for.

<u>Comment</u>: Note that the income inclusion due to the at-risk recapture rules occurs even though there was -0- income or loss from operations in that second tax year.

<u>Comment</u>: Applying these examples to the real estate industry where "qualified nonrecourse real property indebtedness" is allowed to be included for at-risk purposes on **Form 6198**, there would be no change in the results mentioned where a subsequent event caused this debt to be shared in different proportion (due to factors such as those mentioned above) than that originally calculated in an earlier tax year. Or, if the principal amount of the mortgage was paid down (before other sources of at-risk basis were created).

☞At-Risk Recapture - When a Partnership With Deficits in Partners' Capital Accounts Makes S Election

1. When a partner has properly used "soft basis" (i.e., "OPM" or "other people's money") to create at-risk basis for taking K-1 losses to the extent that there is a deficit in their capital account (even though their tax basis in their partnership interest can never go below zero), and then the entity decides to make an S election, disastrous tax results can occur.

    a. The main reason for this is that guaranteed debt, including "qualified nonrecourse real property indebtedness," no longer counts for "at-risk basis" purposes in an S corporation setting

    b. "Direct shareholder loans" are the only type of liability found on an S corporation's balance sheet which can serve to create additional basis (i.e., "debt basis") beyond that resulting from capital contributions and previously-tax but undistributed income (i.e., "stock basis")

Example 7: A, B and C are equal members of a real estate development LLC. Due to large expenses in the early years of the development process, the entity has incurred significant losses thus far which were passed through to the members on their respective K-1s. Even though their "hard basis" (i.e., capital contributions the partners made in forming the partnership) has long since been used up in taking these losses on their personal returns, they were able to absorb even more of the losses due to the fact that they each served as co-guarantors of the LLC's outstanding debt. In fact, each of them showed a $100,000 deficit in their respective capital accounts.

Now, as the entity is about to earn significant profits from selling off their inventory of improved lots in an ever-improving real estate market, they file a **Form 2553** S corporation election effective as of the first day of the next tax year (which their tax advisor becomes aware of in late-March when finishing up their most recent **Form 1065** return). What impact, if any, would this have on each of the LLC members?

Since it is too late to retroactively revoke their S election, under the **Code §465(e)** "at-risk recapture rules" A, B and C would have to each pick up $100,000 of ordinary income (on Schedule E, page 2) due to the deficits in their respective capital accounts as this "qualified nonrecourse real property indebtedness" is no longer allowed for purposes of calculating either their stock or debt basis of the new S corporation.

Comment: Even if the partners decided to dissolve the partnership and distribute out the assets pro rata to each partner (who would now hold them as tenants-in-common), and then contribute them to a newly-formed S corporation pursuant to **Code §351** (i.e., receiving back only stock and no "boot"), **Code §357(c)** would still treat the excess of any liabilities over the adjusted bases of assets transferred into the corporation as "boot." And, this would be in spite of the fact that these new shareholders remained liable as guarantors on this debt.

☞**Passive Loss Rules Limit Deduction of K-1 Losses:** In addition to complying with the basis requirements and at-risk rules, a taxpayer may be limited in the use of a deduction, loss or credit from an business when he or she is otherwise subject to the passive loss rules. Under the passive loss rules, a loss or credit from a passive activity may only be used to the extent the taxpayer has income from that or other passive activities. The rules are applicable to individuals, estates, trusts, personal service corporations, and to a lesser extent, closely-held C corporations. Passive activities include all trades or businesses in which the taxpayer does *not* materially participate, as well as *automatically* for rental activities. Certain limited exceptions apply for "real estate professionals," and when a qualified grouping election is made.

If passive activity losses exceed a taxpayer's passive activity income, the losses are suspended until the taxpayer has sufficient income from the activity giving rise to the passive loss or from some other passive activity. The losses also cease to be suspended when the taxpayer disposes of the *entire* interest in the activity in a *fully taxable* transaction.

Unlike the at-risk rules, with one exception, the passive loss rules do *not* depend on the **liability of the participants** of the organization. Instead, they are based on the taxpayer's **participation** in the activity. The statute provides that a limited partner is only considered to materially or actively participate to the extent provided in the regulations. However, the term "limited partner" is *not* defined in the statute. Therefore, it is necessary to determine what a limited partner is for purposes of the passive loss rules.

Temporary regulations issued in 1989 provided some additional guidance on this issue. Under these regulations, a limited partnership interest is an interest in a partnership which either:

- Is designated as a limited partnership interest in the certificate or limited partnership agreement, or

- Is an interest where the liability of such partner is limited to a fixed and determinable amount (such as contributions to capital or obligations to contribute to capital) under state law.

This definition appears to encompass all members of an LLC regardless of their degree of participation and differs from the definition used for classification purposes. But, if an LLC member is treated as a general partner, either as a result of being a manager or simply by participating in management as a member in a member-managed LLC, that member is **not** subject to the more restrictive rules applicable to limited partners. An individual LLC member is determined to **materially participate** in an activity during a taxable year if the member meets any **one** of the following tests:

1. The individual participates for **more than** *500 hours*.

2. The individual's participation in the activity **constitutes substantially all of the participation** in such activity by all of the participants (including nonmembers).

3. The individual participates in the activity for ***more than 100 hours*** and no other individual participates in the activity more than the individual.

4. The activity is a "significant participation activity" and the individual's aggregate participation in all significant participation activities **exceeds** *500 hours*.

5. The individual materially participated in the activity for **five of the preceding 10 taxable years**.

6. The activity is a ***service activity*** and the individual materially participated in **any three preceding years** (regardless of whether consecutive).

7. Based on the facts and circumstances, the individual participates on a **regular, continuous, and substantial basis**.

Comment: Limited partners have great difficulty materially participating. But LLC members, particularly member-managers probably should **not** automatically be considered limited partners. Even non-manager members should **not** be considered if they can meet the other tests of material participation, particularly the 500 hour test.[8]

☞Adverse Effect of Making PAL Grouping Elections

Careful thought should be given with regard to a real estate professional making a grouping election under the PAL rules so as to be able to materially participate in an underlying rental activity. Consider the case of a REP who also owns a number of rental properties, yet cannot prove that he meets at least one of the material participation tests on any one of the separate rental properties (e.g., 100 hours and *not* less than anyone else involved in the activity, let alone the 500-hour test). So, a grouping election is made to treat (on an "all-or-nothing basis") **all of these rental properties as just "one" activity** for

[8] Gregg v. U.S., 186 F.Supp.2d 1123 (D. Or. 2001).

purposes of the passive loss rules.

Furthermore, at the time that the election is made, assume that there are significant suspended losses as to some of the properties. In a subsequent tax year, and before these suspended losses are freed up (i.e., by having sufficient passive income to cover them), some of the "loss" properties are sold. And, in fact, given the current state of the economy, they are sold at a sizable loss. These losses would be reported on **Form 4797** as Sec. 1231 ordinary losses. But, since the taxpayer's "entire" interest in this passive activity (i.e., since it is comprised of **all of the rental properties** that the taxpayer owns) is *not* being sold in this transaction, the PAL "disposition" rule is *not* available and the suspended losses associated with the properties that were sold remain listed on the taxpayer's **Form 8582**.

> **Comment:** The "moral of the story" is that, if a taxpayer foresees the disposition of some of the rental properties before sufficient passive income is available to free up any suspended passive losses associated with these properties, the grouping election should be delayed until after the sale (i.e., so the PAL "disposition rule" can be used to free up these losses, regardless if there is gain or loss on the sale).

> **Comment:** A grouping election should also be delayed where, for instance, rental property is going to be sold at a gain, but a **Code §1031** LKE is going to be used. Then, any gain can avoided except to the extent that passive income is needed to free up current or suspended losses for the properties being sold, or for other suspended passive losses listed on **Form 8582**. And, if gain is needed to generate passive income, the exact amount can be generated simply by financing (to the extent needed) the purchase of the qualified replacement in the LKE instead of consuming all of the monies held in the qualified intermediary's escrow account.

> **Comment:** Grouping elections for rental properties made by a real estate professional should maybe be avoided where there might be a minimal rental loss in the aggregate for such properties, but it is anticipated that significant rental income will be generated in the near future (and, it might as well be a passive source of income).

☞TCJA Code Sec. 461(l) "Excess Business Deduction" Explained

Generally speaking, **Code §461** was amended TCJA to include "subsection (l)," which limits the use of "excess business losses" (EBLs) for *noncorporate* taxpayers (e.g., individuals, trusts and estates) to $250,000 ($500,000 MFJ filers). This limitation is effective for taxable years beginning *after* December 31, 2017, and *before* January 1, 2026.

> **Note: CARES Act delayed implementation of Sec. 461(l) to 2021.**

An EBL is basically the *aggregate* of business deductions over the sum of the aggregate gross income derived from any "trades or businesses" of the taxpayer, limited to a $250,000 loss ($500,000 MFJ filers). This calculation combines an individual's multiple business interests to get to the "combined business loss limitation" that is then used to offset *nonbusiness* income. **Code §461(l)** is similar in concept to existing **Code §461(j)**, which limits excess farm losses attributable to farming businesses of a taxpayer.

> **Comment:** Presumably, the **Code §461(l)** limitation amounts will be adjusted for inflation annually for taxable years beginning *after* December 31, 2021 (i.e., since the provision first takes effect in 2021 v. the original 2018 date). Also, for partners in a partnership or shareholders in an S corporation, this limitation is taken into account at the individual level.

To clarify, this is *not* simply an overall cap on the utilization of an "net operating loss" in a post-2017 tax year. Instead, it is a *separate* provision which first compares the aggregate amount of "business deductions" to a noncorporate taxpayer's overall "business income." More importantly, **Code §461(l)** does *not* even come into play until the taxpayer has applied other "limiting provisions" to any business losses first. Namely, the taxpayer would have to have sufficient "basis" to take the loss (i.e., under **Code §704(b)** for partners and **Code §1366** for S corp shareholders). Then, given there is sufficient "basis" to take the loss, the **Code §465** "at-risk" limitations (i.e., as determined on **Form 6198**) are applied next. The greatest hurdle to overcome with regard to taking a business or rental loss comes next in the form of the "passive loss rules" under **Code §469**. Given that all of these "loss restriction barriers" are satisfied, the new (i.e., in 2018 onward) **Code §461(l)** "excess deduction loss" rules now take over. As explained in the following example, "business deductions" can be used to the extent of "business income" (which is defined by the IRS below). Then, the use of any "excess of business deductions" would be limited to the new $250,000/500,000 cap with the carryover (if any) being treated as an NOL (i.e., pursuant to the normal **Code §172** rules) to be used in future tax years.

IRS Definition of "Business Income": An "excess business loss" is the amount by which the total deductions attributable to all of a noncorporate taxpayer's "trades or businesses" exceed their total gross income and gains attributable to those trades or businesses, plus $250,000 (or, $500,000 in the case of a joint return). A "trade or business" can include, but is *not* limited to, **Schedule F** and **Schedule C** activities, **but *not* the activity of being an employee (i.e., the "wages" reported on the W-2)**, an activity reported on **Form 4835, Farm Rental Income and Expenses**, and other business activities reported on **Schedule E**. Business gains and losses reported on **Form 4797, Sales of Business Property** and **Form 8949, Sales and Other Dispositions of Capital Assets** can be included in the excess business loss calculation. "Trade or business income" also includes K-1 "flowthrough income and losses attributable to a trade or business (i.e., impact of items reported in **Boxes, 1,2, 4, 9c, 10, 12**). This includes farming losses from casualty losses or losses by reason of disease or drought. "Excess business deductions" that are disallowed are treated as a "net operating loss carryover" to the following taxable year. **Form 461** and **instructions** should be consulted for more details.

Example: "Calculation of Excess Business Deduction Starting in 2021"
A single taxpayer has $300,000 of interest and dividends, $500,000 ordinary loss (e.g., K-1, Box 1 T/B loss) from a partnership and $100,000 of ordinary income (e.g., K-1, Box 1 T/B income) from an S corp with material participation in both business activities. Under *pre-TCJA* rules, this would result in a $100,000 taxable loss for the taxpayer ($300,000 - $500,000 + $100,000). But, under the *new* rules, the two "business interests" are first combined to get an overall loss of $400,000, which is then limited to $250,000 under the **Code §461(l)** EBL limitations which can be used to offset the $300,000 of nonbusiness (i.e., dividend and interest) income for a net positive income of $50,000. This calculation of the EBL would be included on the individual tax return **Form 461, Limitation on Business Losses**, which would be attached to the taxpayer's **Form 1040**. The disallowed $150,000 loss which is the excess of the $400,000 of business and other income over the new limitation $250,000 for a single taxpayer in this example is *not* permanently lost but is instead carried forward as a net operating loss (NOL).

Comment: Keep in mind that the TCJA originally made changes to the NOL rules under **Code §172**. Supposedly, for taxable years ending *after* December 31, 2017, the two-year NOL carryback is no longer in effect for most taxpayers, NOLs are limited to 80% of the "pre-NOL taxable income" (90% of AMTI) and NOLs are carried forward *indefinitely*. **Now, these rules finally take effect for the first time in 2021.**

Comment: For purposes of the Sec. 199A deduction, any "excess business deductions" (EBLs) remaining *after* application of **Code §461(l)** will offset a taxpayer's "qualified business income" (QBI), if any, **in the subsequent tax year**.

Example: "EBLs Offset QBI in Subsequent Tax Year"
Using the facts from the **Example** above, the "excess business deduction" carryover of $150,000, since it would have *not* reduced any QBI of the taxpayer **in 2021**, would now have to be carried over to reduce QBI, if any, that the taxpayer had **in 2022** (or, to a future tax year until fully used up).

Comment: Keep in mind that the rules for pre-2018 NOLs were different. And, these "old" NOLs are used up first on FIFO basis going forward into 2018 and thereafter. In addition, pre-2018 NOLs will *not* serve to reduce post-2017 QBI since they arose in tax years where **Code §199A** was *not* even part of the tax law. This is a similar result as to what the final Sec. 199A regs had to say about pre-2018 suspended passive losses (i.e., as listed on **Form 8582**). On the other hand, post-2017 NOLs (including post-2021 EBLs/"excess business losses" which now get treated as NOLs), freed-up passive losses, Sec. 481 "negative adjustments" will reduce any QBI of the taxpayer to the extent that they are now part of the taxpayer's taxable income calculation.

As mentioned above, the **Code §461(l)** EBL limitations are applied *after* other existing loss limitation rules. So, in the original **Example** above, the taxpayer would still need to have the necessary tax basis, as well as satisfying the at-risk basis rules, in order to take the $500,000 of K-1 T/B loss from the partnership. In addition, if the interests that the taxpayer had in these two flowthrough entities were *both* passive, the combined $400,000 of passive loss (i.e., $500,000 partnership loss less $100,000 of S corp income) would be disallowed under **Code §469** (and, suspended on **Form 8582**) *before* the **Code §461(l)** EBL limitations are taken into account.

Initially, there were some unanswered issues with regard to these new **Code §461(l)** rules. For example, additional clarification was needed with regard to whether W-2 wages or guaranteed payments should be considered "trade or business income." Based on numerous case law decisions, as well as general principles of tax law, individuals who are employees are normally considered to have trade or business income (i.e., "old" **Form 2106** which permitted a a 2% miscellaneous deduction for "unreimbursed employee business expenses"). Nevertheless, the **General Explanation of the Public Law 115-97** (as discussed more fully below) explicitly states it was *not* intended for wage income to be included in the calculation. A footnote does state, however, that it may require a "technical correction" to carry out this rule (which has still *not* been forthcoming from Congress as of this date). But, the **instructions** to **Form 461** seem to clearly indicate that "wages" will be treated as "business income."

Example: "Wages Not Treated as Business Income for Sec. 461(l) Purposes"
In the original Example above, if $100,000 of "wage income" were to be added to the facts given, and if wages were classified as "business income" for purposes of **Code §461(l)**, the existing $400,000 of business losses would be used to offset wages and then limited to $250,000 to offset the interest and dividends for a net taxable income of $50,000 and NOL carryover of $50,000 ($100,000 - $400,000 + $250,000). Conversely, if wages are *not* included as "business income" for purposes of **Code §461(l)**, the $400,000 loss would be limited to a $250,000 loss to offset the $300,000 of interest and dividends and $100,000 of wages, for a net taxable income of $150,000 and NOL carryover of $150,000.

☞**Taking K-1 Losses on Schedule E, Page 2:**

☞**The Critical "Four Steps"** To determine whether a Schedule K-1 loss is deductible on page two of Schedule E, these four steps must be applied in following order:

Step 1: Determine the member's **basis** in his ownership interest.

Step 2: Ascertain what amount, if any, of this initial basis amount is considered **at risk**.

Step 3: Determine whether the **passive loss rules** apply, and limit the loss to any passive income if the owner does **not** materially participate in the underlying trade or business of the LLC.

Step 4: Determine if "excess business loss deduction" limit under **Code §461(l)** applies

Comment: As previously mentioned, **"Step 2"** is an evaluation of the risk the owner might actually bear for his share of LLC liabilities allocated in **"Step 1"** (under **Code §752(a)**). **"Step 4"** is a new consideration for tax years beginning in 2021.

Comment: Certain exceptions, such as the "active rental real estate exception," or the "disposition rule" might allow excess passive losses to be deducted.

Example 1: "Keeping Track of Suspended Losses"

Ben contributes $10,000 cash to an LLC and receives a 50% interest in return. At the end of the first tax year, the LLC borrows $60,000 to purchase equipment without any of the members guaranteeing the debt. But, Ben lends $40,000 to the LLC personally (and, this debt is *not* guaranteed by any of the other partners), but does **not** otherwise materially participate in the business operations. The LLC incurs a loss for its first tax year. Ben's distributive share of the loss is $50,000.

Comment: Since the losses discussed below do not exceed the applicable $250,000/500,000 thresholds, the **Code §461(l)** "excess business loss deduction" rules do *not* come into play.

Question 1A - Step 1: What is Ben's basis, assuming no distributions are made during the year?

Answer 1A: Ben's initial basis of $80,000 is calculated as follows: $10,000 cash contributed + $40,000 personal loan to LLC + $30,000 allocable share of the LLC's nonrecourse debt.

Given the loss of $50,000 on the member's Schedule K-1, Ben's $80,000 basis is sufficient to deduct the entire loss, subject to at-risk and passive-loss limitations.

Question 1B - Step 2: What part of his basis is considered at risk?

Answer 1B: Of Ben's $80,000 basis (from **Step 1**), only $50,000 is considered at risk for purposes of **Step 2**. This is because Ben bears no economic risk of loss for his share of the LLC's nonrecourse debt of $30,000. In other words, if the LLC fails to pay this portion of the debt, Ben will never be personally liable for its repayment.

Comment: Ben's $40,000 personal loan to the LLC is considered at risk because he personally advanced these funds to the LLC. And, since $50,000 of Ben's initial basis of $80,000 is considered at risk, all of the $50,000 K-1 loss is deductible even after applying **Step 2**.

Question 1C - Step 3: How do the passive loss rules limit the deduction of this $50,000 loss on Ben's Schedule E, page 2 if he has no other sources of passive income?

Answer 1C: Since Ben does **not** have any passive income, none of the $50,000 loss can be deducted on Schedule E, page 2. Instead, this $50,000 is suspended and listed on the Form 8582 worksheet.

Example 2: "Keeping Track of Suspended Losses"

Use the same facts as **Example 1** except the LLC incurs a $200,000 loss for its first tax year, with Ben's distributive share of the loss being $100,000. Furthermore, assume that Ben has $30,000 of passive income from other sources.

Question 2A: What is Ben's basis assuming no distributions were made during the year?

Answer 2A: Ben's basis is $80,000 under **Step 1** (i.e., the *same* as in **Example 1**). Therefore, $20,000 of the total $100,000 K-1 loss is suspended due to the lack of basis.

Question 2B: What part of this basis is considered at risk?

Answer 2B: Ben's at-risk basis in **Step 2** is again $50,000. Therefore, $30,000 of the total $80,000 loss allowed in **Step 1** is suspended under the at-risk rules.

Question 2C: How do the passive loss rules limit the deduction of this $100,000 loss on Ben's Schedule E, page 2 given he has $30,000 of passive income from other sources?

Answer 2C: Since Ben has $30,000 of passive income, $30,000 of the total $50,000 loss allowed from **Step 2** (under the at-risk rules) is allowed and listed on Schedule E, page 2. The remaining $20,000 loss suspended due to the lack of passive income is listed on the **Form 8582** worksheet.

Example 3: "Taking Suspended Losses in Subsequent Tax Year"

From **Example 2**, $70,000 of the first year $100,000 loss is suspended (i.e., $20,000 due to the lack of basis, $30,000 under the at-risk rules and $20,000 due to the lack of passive income) with only $30,000 of the original $100,000 ultimately being allowed as a deduction on page 2 of Schedule E. In the second year of its operation, the LLC is successful and reports an allocable share of trade or business income on Ben's Schedule K-1 of $50,000. However, assume that Ben continues to hold this interest strictly as an investment and does **not** materially participate in the LLC business. He has no other sources of passive income in the second year and there was no change in the LLC debt, nor were there any distributions made.

Question 3A: What is the effect of this LLC income on Ben's basis?

Answer 3A: The three steps are applied as follows:

Step 1: Ben's basis of zero from Year 1 is now increased to $50,000.

Step 2: Since this source of basis was from Ben's share of LLC income, and **not** from his share of LLC debt, (i.e., under Code §752(a)) it need *not* be tested for purposes of the at-risk rules.

Comment: Sometimes this type of basis is referred to as **"hard basis."** The same is true of basis derived from capital contributions of either cash or property. On the other hand, basis derived from a share of LLC debt is referred to as **"soft basis"** and must always be tested under the at-risk rules.

Step 3: This $50,000 of K-1 income is also considered passive income.

Question 3B: Are any of the suspended losses from Year 1 freed up and now available to report on Ben's Schedule E, page 2 in this second tax year?

Answer 3B: Yes. Ben is now able to deduct $50,000 of suspended losses from Year 1, computed as follows:

Step 1: Since Ben now has $50,000 of basis in his LLC interest, the $20,000 of suspended loss from Year 1 (due to lack of basis) is allowed as follows:

Basis at beginning of Year 2	$ -0-
Share of Year 2 LLC income	50,000
Basis at end of Year 2	$50,000
Year 1 loss suspended due to lack of basis	(20,000)
Final Step 1 basis at end of Year 2	$30,000

Step 2: Since the $50,000 basis increase is due to Ben's allocable share of LLC income (and **not** due to a change in his share of LLC debt), all of this increase is considered at risk. Therefore, Ben's at-risk basis of zero at the beginning of Year 2 increases by $50,000. This results in **all** of the at-risk suspended loss of $30,000 from Year 1 being allowed as follows:

At-risk basis at beginning of Year 2	$ -0-
Increase to at-risk basis due to Ben's share of Year 2 LLC income	50,000
Basis at end of Year 2	$50,000
Year 1 loss suspended due to zero at-risk basis	(30,000)
Final Step 2 at-risk basis at end of Year 2	$20,000

Step 3: Even though Ben's share of LLC income is also considered passive, this $50,000 would **not** free up any of the $20,000 suspended passive loss from Year 1 since **all** the $50,000 income from Year 2 was already absorbed by the suspended *basis* loss of $20,000 and suspended **at-risk** loss of $30,000. Therefore, this remaining $20,000 suspended passive loss continues to be shown on the Form 8582 passive loss worksheets, as follows:

Suspended loss at end of Year 1 (on Form 8582)	$20,000
LLC income available from Year 2	-0-
Passive loss still suspended at end of Year 2	$20,000

To summarize, since Ben received an allocable share of LLC income in Year 2 equal to $50,000, he is now able to take $50,000 of the $70,000 loss suspended from Year 1. He shows this as a separate item on Schedule E, page 2, line 28 (i.e., he would list this year's income of $50,000 on line 28A. and, on the next line 28B., last year's carryover loss of ($50,000)). Also, Ben must also check "yes" for the box on line 27 since he is taking a loss suspended from a prior tax year. The remainder of the suspended $20,000 loss from Year 1 continues to be shown on the Form 8582 passive loss worksheets and is carried over to Year 3.

Example 4: "Effect of Distribution on Basis in Break Even Year"

Assume that Ben has $80,000 of basis, $50,000 of which is considered at-risk. However, he has no sources of passive income and does **not** materially participate in the LLC. His allocable share of the LLC's loss is $100,000. Once again, $20,000 of the loss is suspended due to the lack of **Step 1** basis ($100,000 – $80,000). Of the $80,000 loss allowed in **Step 1**, $30,000 is suspended due to the lack of sufficient **Step 2** at-risk basis ($80,000 – $50,000). None of the $50,000 is allowed under the **Step 3** passive loss rules because Ben has no other sources of passive income. But, of the $100,000 LLC loss shown on Ben's Schedule K-1, **none** of it is allowed on Schedule E, page 2. Nevertheless, Ben's **Step 1** basis is zero at the end of the first tax year. Now, in Year 2, when the LLC broke even, assume that he receives a $25,000 distribution.

Question 4A: Would the distribution be taxable if the LLC reports no income in Year 2?

Answer 4A: Even though none of the Year 1 $100,000 Schedule K-1 loss was allowed after applying the "three steps," Ben's original basis of $80,000 as of the beginning of Year 1 basis was fully reduced to zero. Therefore, the **entire** $25,000 distribution is taxed. This occurs because the Year 1 loss is considered to have absorbed Ben's entire $80,000 **Step 1** basis (which is the key when testing the taxation of a distribution). Furthermore, the LLC reported no income in Year 2 (which would have been added to Ben's basis first, had any profit occurred as seen in **Question 4B** below).

Question 4B: How does the answer change if the LLC is profitable for Year 2 and Ben's K-1 share is $10,000?

Answer 4B: Ben's zero basis from Year 1 is first increased to $10,000 due to his share of the LLC's income reported to him on his Schedule K-1.

As a result, only $15,000 of the total $25,000 distribution is taxed as follows:

Basis at end of Year 1	$ -0-
K-1 profit for Year 2	10,000
Available basis for distribution	$ 10,000
Less distribution	(25,000)
Excess distribution (taxable in Year 2)	($15,000)

Comment: The most critical point to understand and appreciate regarding the above example is that even through Ben received absolutely no tax benefit from the $100,000 Schedule K-1 loss in Year 1 (because the loss suspension rules limited any of the loss from being deducted currently), his basis going into Year 2 is still zero. And, it is the **Step 1** basis in a member's ownership interest that is used to measure possible taxation of a distribution made during the tax year.

Example 5: "Effect of Distributions on Basis in Profitable Years"

Use the **same** facts as **Example 4** with Ben's basis being zero at the end of the Year 1. Assume that he receives a $25,000 distribution during March of Year 2.

Question: How would the distribution be taxed if Ben's share of the LLC profit in Year 2 was $50,000?

Answer: Although Ben technically has a zero basis in March of Year 2 when he actually receives the cash distribution, he can anticipate the restoration of sufficient basis by the end of the tax year to cover this amount. This is due to his share of the anticipated LLC profit.

Consequently, his **Step 1** basis is first increased from zero to $50,000. Then, it is reduced by the $25,000 distribution taken earlier in the year.

The remaining $25,000 of this net **Step 1** basis increase in Year 2 is then available to use the $20,000 suspended loss carried over from Year 1 due to the lack of sufficient **Step 1** basis. And, given that the remaining $25,000 basis is due to K-1 profit, it is considered at-risk (i.e., it is "hard" basis). As a result, $5,000 of the total $30,000 suspended loss due to the lack of **Step 2** at-risk basis from Year 1 is available. Nevertheless, since all the $25,000 is absorbed by these first two steps, *none* of the $20,000 suspended passive loss from Year 1 is allowed. Consequently, it continues to be listed on Form 8582 and is carried over to Year 3.

Basis at end of Year 1	$ -0-
K-1 profit for Year 2	50,000
Available basis for distribution	$50,000
Distribution	(25,000)
Basis at end of Year 2	$25,000*
Taxable portion of distribution in Year 2	$ -0-

*Note: Used to absorb $25,000 of the suspended loss from Year 1.

Example 6: "Distributions Not Limited to At-Risk Basis"

Larry's basis is zero at the beginning of the tax year. During March, he takes a $50,000 cash distribution. At the end of that tax year, Larry's distributive share of partnership income is $25,000. The partnership also has a nonrecourse liability on its books (other than "qualified real property indebtedness") for which Larry is allocated $30,000 as an increase to his basis.

Question: Will any of the cash distribution made earlier in the year be taxable to Larry?

Answer: Larry's basis is first increased by his distributive share of partnership income for the tax year, in addition to his share of debt as permitted under **Code §752(a)**. Therefore, Larry's basis goes from zero to $55,000 ($25,000 + $30,000) as of December 31. This level of **Step 1** basis is then used to determine if sufficient basis exists to cover the $50,000 distributed earlier in the year.

With $55,000 of basis, there is enough to cover the partnership's $50,000 cash distribution to Larry. It is important to note that the test for possible taxation is **not** based on the partner's **Step 2 at-risk** basis (which is only $25,000). In other words, a partner's basis for purposes of determining the possible taxation of a distribution is determined *before* the application of the at-risk rules.

> **<u>Comment</u>:** The at-risk rules do **not** affect the tax basis of a partner's interest, or the amount of gain or loss realized if he sells his interest. Instead, these at-risk rules merely serve to limit the amount of K-1 loss that may be deducted by a partner in a particular tax year.

☞Using Real Estate LLCs to Loan Monies to LLCs vs. S Corporations

It is very common for businesses to keep the real estate off of the company's balance sheet in order to shield these valuable assets from creditor claims as well as possible litigation. And, the entity of choice is often the LLC to hold title to such properties. Now, considering the discussion above with regard to the effect of liabilities on an owner's basis, consider the following scenario where an LLC business is in need of funds for its day-to-day operations. Furthermore, assume that the LLC holding the real estate is owned by the *same* individuals and in the *same* percentages as the LLC which is operating the trade or business.

The owners proceed to refinance the real estate and cause the monies received to be immediately loaned directly to their business. In other words, the monies were *not* first distributed out of the real estate LLC to the individual owners (who would have sufficient basis given the increase caused by this new mortgage as "qualified real property indebtedness" in the first place) who would then loan them to the business. Nevertheless, each member of the LLC operating the business would still have an increase to their respective bases due to the overall increase in the LLC's liabilities.

Now, consider the same scenario with an S corporation which is in need of additional funds for operations. The shareholders also own an LLC in the same percentages as the corporation and decide to refinance the real estate that it holds title to. The key here is that the monies **are lent directly from the real estate LLC to the S corporation**. Even if the LLC's debt mortgaged by the real estate is also **personally guaranteed** by the S corporation shareholders, they **will receive no step-up in basis** due to this new debt on the company's balance sheet (i.e., the loan that it now owes to the LLC). Instead, they should have first distributed the monies out of the LLC to themselves individually and then lent it to their S corporation as direct shareholder loan. Only in this way could the debt have increase their stock basis.

> **<u>Comment</u>:** It's a shame that even though the S shareholders might be personally called upon to repay this debt, they will receive no corresponding basis increase in their stock until such time that this might actually occur. Merely by recasting this loan as coming directly from themselves would a more preferable result occur.

☞Refinancing Real Estate Held by LLC to Ease Admission of New Members

It was not unusual to see significant appreciation in real estate assets during the period before 2008 (and, also a bit more recently, especially on the two U.S. coasts). And, if the real estate is held as tenants-in-common, it might be for new owners (e.g., family members) to come into the picture. However, if the real estate is instead held by a separate entity such as an LLC, the admission of new owners might be facilitated by first refinancing the property and encumbering it with more debt thereby driving down the net fair market of the property. As a result, the purchase price might be more affordable for these potential new owners. Also, the **debt might be personally guaranteed by just these original owners** so any new purchaser would *not* become liable for its repayment. Nevertheless, consider the illustration below where the distinction between an LLC vs. an S corporation incurring more debt might backfire from a tax standpoint.

Example 4: "Refinancing Real Estate Eases Admission of New LLC Members"

An LLC with three equal members owns a commercial building valued at $600,000. There is no debt on the property and the members each have a basis in their LLC interest equal to $80,000.

Two additional individuals wish to buy into the LLC, but **cannot afford** the current admission price of $120,000 ($600,000 ÷ 5). Therefore, the LLC secures a mortgage in the form of a qualified nonrecourse debt on the property in the amount of $300,000. With the cash proceeds in hand, the LLC makes a current nonliquidating distribution of $100,000 to each of the original three members. The two new members are then able to purchase their LLC interests for just $60,000 (i.e., $300,000 FMV/5 LLC members).

The outside bases of each of the original three members increased from their current levels of $80,000 (before the new mortgage was obtained) to $180,000.[9] When the cash distributions are made to the three members, their bases return to their original level of $80,000 each. With the admission of the two new members, the debt is then shared in five equal portions. This reduces the original basis of each of the original three members to $40,000 (The $300,000 mortgage initially shared three ways is now shared five ways.) This results in a basis reduction of $40,000 (i.e., $100,000 down to just $60,000) for each to the three original members.[10]

For the original members, there is no tax effect when the decrease in the sharing of the liability (which is treated as a deemed cash distribution) caused by **Code §752(b)** occurs. This is because it lowers the bases of the three original members by $40,000. The original members have sufficient basis in their respective interests to absorb this decrease. Sharing the new liability allows the two new members to afford to buy a 20% interest in the LLC.

	Each Original Member's Basis
Beginning adjusted basis of capital interest	$ 80,000
Share of $300,000 mortgage	100,000
Cash distribution	(100,000)
Basis after admission of new partners	$ 80,000
Share of mortgage assumed by new partners	(40,000)
Basis after admission of new partners	$ 40,000

Comment: This example again illustrates one of the potential advantages of a partnership/LLC when it comes to the effect of liabilities on owner basis. In comparison, S corporation debt has no effect on a shareholder's basis unless it represents a direct loan from that particular shareholder

[9] IRC §752(a)

[10] IRC §752(b)

to the entity (guarantees do *not* count until such time as that owner actually has to repay the debt of the entity). In **Example 4**, as an S corporation, refinancing the property for $300,000 and then making a distribution of $100,000 results in an immediate capital gain to each of the original owners equal to $20,000 ($80,000 basis – $100,000 distribution) since the debt does *not* serve to increase their respective bases, even if they are required to guarantee such debt (the lender requires this additional security along with the property serving as collateral).

☞**Special Allocations - Partnership K-1 Items**

Comment: Special allocations are preferable to guaranteed payments since the latter serve to reduce "qualified business income" that the entity might otherwise have.

The other two remaining requirements under the Code for special allocations would be that capital accounts were maintained and that, if there was a deficit in this particular partner's capital account, he would be required to make a sufficient contribution to restore that balance back up to zero before exiting the partnership (i.e., a "deficit restoration order" or DRO).

There are three specific requirements under **Code §704(b)(2)** for partnerships intending to make special allocations of K-1 items in a particular tax year. The most important one is that there be "substantial economic effect" for the allocation (as opposed to it only being done strictly for a more favorable tax result to a particular partner). In a client's situation where the banks had refused to lend any more monies to the business, and with the losses that it had incurred to-date, there was no source of funds to finance continued operations. Therefore, an individual partner decided to contribute (v. lend) an additional $250,000 to the entity which allowed the business to stay afloat, at least for the most current tax year when it incurred over $350,000 in losses.

A fair allocation in this instance, which should be committed to writing as an addendum to their partnership agreement (although, no special statement need to be included with either the Form 1065 or the partner's personal tax return), is that the first $250,000 of the current tax year loss (which was financed by his capital contribution) would be specifically allocated to his K-1, with the remainder of the $350,000 overall loss being allocated based on their respective ownership percentages. **(Code §704(b)(2); Special Allocations)**

Example: Consider a tax practice equally owned by two partners. In the year just ended, though, John who is nearing retirement spent an extraordinary time in FL honing his golf swing and lowering his handicap. Meanwhile, his partner back at the firm ended up putting in 75% of the overall chargeable hours for the year.

At their annual partner meeting, it was agree that despite their 50/50 ownership, John would only receive 25% of the bottom line profit, while 75% of the remaining profit would be specially allocated to the other partner. This was done instead of giving the other partner a set amount as a guaranteed payment to compensate him for all of the extra time that he devoted to the practice. What is the impact, if any, on the total amount of "qualified business income" under **Code §199A** for purposes of the 20% deduction?

☞**Sec. 704(b)(2) "Special Allocations" v. Guaranteed Payments to Maximize Sec. 199A Deduction**

Even though a partner's receipt of a "guaranteed payment" for services performed for the entity is closely aligned with that of a "salary" paid to the owner of a closely-held S corporation, Sec. 199A sees it much differently. Even though the wages paid to an owner/employee of an S corporation serve to reduce overall "qualified business income" (QBI), they are available (along with any wages paid to rank-and-file employees) as a support for a potential Sec. 199A deduction. Of course, if a taxpayer's taxable income, before any Sec. 199A deduction, is *below* the applicable "threshold" (i.e.,end of the 24% marginal tax bracket), then the "QBI component" (i.e., 20% x net QBI) is allowed regardless of any "wages" being paid, or UBIA.

In a partnership setting, however, guaranteed payments to partners only serve to *reduce* overall QBI, while providing *no support* for an possible Sec. 199A deduction. As a result, partners should instead look to the use of "special allocations" when seeking to share the profits of the partnership. As long as the special allocation has "substantial economic effect" (as opposed to being done solely for tax purposes), it will be respected if challenged by the IRS.

Example: "Using Special Allocations v. Guaranteed Payments"
John and Dennis have an accounting firm partnership that specializes in tax preparation and consulting. Initially, they agree to a 50/50 split as to all income, deductions and credits resulting from the business. However, when Dennis joined the firm, he insisted on a guaranteed payment of $10,000/month ($120,000/year) and has this put in writing in their partnership agreement. John, on the other hand, being a golf fanatic decides to spend most of Jan. through Mar. in FL seeking to lower his handicap to single digits. This leaves Dennis with the task of getting most of the clients' returns out the door by himself, along with a few staff members. At the end of the year, after paying all of the firm's expenses, a profit of $400,000 is realized, *before* the guaranteed payment to Dennis is factored into the equation.

If the $120,000 guaranteed is deducted on page one of Form 1065, the firm's QBI is *reduced* from $400,000 to $280,000 (which would then be split 50/50 with $140,000 going to each partner as reflected in Box 1 of their respective K-1s). Instead, even if it is done *after* yearend (but by the unextended March 15th due date of the partnership return), Dennis and John can modify their partnership agreement to take into account that Dennis had most of the chargeable hours during the past busy season, thereby justifying a "special allocation" of $120,000 of the firm's $400,000 profit going initially to him. This would result in $360,000 being shown in Box 1 of his K-1, while John would have the remaining $140,000 being reflected in Box 1 of his K-1.

Instead of $280,000 of QBI when $120,000 of the firm's profits are subtracted as a "guaranteed payment" on page one of the Form 1065, "qualified business income" would now remain at $400,000. Furthermore, Dennis would pay self-employment tax on $360,000 (as shown in Box 14 of his K-1) regardless of him receiving this "guaranteed payment" as opposed to a "special allocation" of the same amount. More importantly, this allocation has "substantial economic effect" because it is based on the work effort and resulting profit stemming from the chargeable hours brought in by each partner. **(Code §704(b)(2); Special Allocations**)

☞**IRS Proposes Methods for Reporting Partner Capital Accounts** (**Notice 2020-43**)
The IRS is proposing two new methods for reporting partner capital accounts on **Form 1065**. The new methods are proposed to apply to partnership tax years that end *on or after* Dec. 31, 2020 and are intended to be the "exclusive methods" for such reporting.

Comment: This continues to be the guidance that we have when preparing 2023 tax year returns.

Background: Partnerships report partner capital accounts in **Box L** on the **Schedule K-1 (Form 1065 (U.S. Return of Partnership Income))** as currently reflected on the 2019 forms (i.e., **Tax Capital Reporting Requirement**).
On April 5, 2019, the IRS released **Form 1065 Frequently Asked Questions (FAQs)** explaining how

a partnership should determine a partner's tax capital account and providing a "safe harbor approach" based on a partner's outside basis in its partnership interest. Thereafter, early releases of drafts of the 2019 **Form 1065** expanded partner tax capital reporting to require *all* partnerships to report partners' tax capital accounts using the "tax basis method." But, tax professionals objected that partnerships that failed to historically maintain partner tax accounts would *not* be able to comply with this requirement.

As a result, the IRS released **Notice 2019-66** which removed the requirement that partnerships filing **Form 1065, Schedule K-1** report partner capital accounts in **Item L** of the **2019 Form 1065, Schedule K-1**, using the "tax basis method" for 2019.

New IRS Proposed Methods: In this Notice, the IRS is proposing two new methods, the **Modified Outside Basis Method** and the **Modified Previously Taxed Capital Method**, for meeting the **Tax Capital Reporting Requirement** and anticipates that the two proposed methods will be the *only* methods that meet this requirement for partnership tax years ending *on or after* December 31, 2020. Furthermore, once selected, that method must be used consistently for all partners of a particular partnership.

For tax years *after* 2020, however, a partnership is permitted to change its **Tax Capital Reporting Requirement** method from the **Modified Outside Basis Method** to the **Modified Previously Taxed Capital Method**, or vice versa, by attaching a disclosure to *each* Schedule K-1 describing the change, if any, to the amount attributable to each partner's beginning and end of year balances, and the reason for the change.

Under another technique, which IRS calls the **Transactional Approach**, partnerships maintaining tax capital:

i. Increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and

ii. Decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner.

Nevertheless, the Service has now announced that capital account amounts based on the **Transactional Approach** will *not* satisfy the **Tax Capital Reporting Requirement** going forward.

Modified Outside Basis Method: Under this method, a partnership determines, or is provided by its partners, the partner's adjusted basis in their partnership interest, determined under the principles and provisions of subchapter K, and subtracting from that basis the partner's share of partnership liabilities under **Code §752**. If the partnership is satisfying the **Tax Capital Reporting Requirement** by using this method, a partner must notify its partnership, in writing, of any changes to the partner's basis in its partnership interest during each partnership tax year, other than:

a. Changes attributable to contributions to and distributions from the partnership, and

b. The partner's share of income, gain, loss, or deduction that are otherwise reflected on the partnership's schedule K-1.

The partner must provide this written notification of such changes to the partner's basis within thirty days or by the tax year-end of the partnership, whichever is *later*. For example, if a person purchases an interest in a partnership that has chosen to use the **Modified Outside Basis Method**, the purchasing partner must notify the partnership of its basis in the acquired partnership interest, regardless of whether the partnership has an election under **Code §754** in effect or has a "substantial built-in loss," as defined in **Code §743(d)**, at the time of such interest purchase. For purposes of the **Modified Outside Basis Method**, a partnership is entitled to rely on the partner basis information that the partnership is provided by its partners "unless the partnership has knowledge of facts indicating that the provided information is clearly erroneous."

Modified Previously Taxed Capital Method: Reg. §1.743-1(d)(1) generally provides that a partnership interest transferee's share of the adjusted basis of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's "previously taxed capital, plus the transferee's share of partnership liabilities." The reg further provides that the transferee's "previously taxed capital" is equal to:

i. The amount of cash that the partner would receive on a liquidation of the partnership following a hypothetical transaction; increased by

ii. The amount of tax loss (including any "remedial allocations" under **Reg. §1.704-3(d)**) that would be allocated to the partner from the hypothetical transaction; and decreased by

iii. The amount of tax gain (including any "remedial allocations" under **Reg. §1.704-3(d)**) that would be allocated to the partner from the "hypothetical transaction." The hypothetical transaction is a disposition by the partnership of *all* of its assets in a *fully taxable* transaction for cash equal to the fair market value of the assets. (Cf. **Reg. §1.743-1(d)(2)**).

The **Modified Previously Taxed Capital Method**, however, modifies the calculation described in **Reg. §1.743-1(d)(2)** (for purposes of the **Tax Capital Reporting Requirement** only) as follows:

i. The cash a partner would receive on a partnership liquidation and calculations of gain and loss in the "hypothetical transaction" would be based on the assets' fair market value, if readily available. Otherwise, a partnership may determine its partnership "net liquidity value and gain or loss" by using such assets' bases as determined under **Code §704(b)**, GAAP, or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management; and

ii. All liabilities are treated as *nonrecourse* for purposes of parts (ii) and (iii) of the calculation referring to gain or loss, respectively. This is intended so as to "avoid the burden of having to characterize the underlying debt and to simplify the computation." **(Code §§704 & 743; Partnership Capital Reporting)**

Code §751 - Hot Assets:

☞**Installment Method Not Available for Sale of Unrealized Receivables (*Mingo*, 114 AFTR 2d ¶ 5518 (5th Cir., 12/09/14))**

The 5th Circuit, *affirming* the Tax Court, has held that an individual was *not* permitted to report the sale of her partnership interest on the installment basis, at least for that portion of the proceeds attributable to the partnership's unrealized receivables (i.e., "hot assets"). In this instance, the year in which the sale had originally occurred was closed. Nevertheless, the IRS was permitted to require her to include income in the following year (i.e., in the earliest tax year which was still open under the statute of limitations) as an accounting method adjustment. (**Code §751**; **Hot Assets**)

> **Comment:** The taxpayer here was a partner with PriceWaterhouseCoopers in their consulting division when it was sold to IBM. She then tried to report the entire gain (including that from unrealized cash basis receivables) on the installment method.

Code §752 - Treatment of Certain Liabilities:

☞**LLC K-1 Losses Not Allowed Since Member Lacked Sufficient Basis (*Bryan*, TC Memo 2023-74 (6/20/2023))**

The taxpayer and his wife owned interests in multiple limited liability companies (LLCs). The taxpayer claimed that he gave (1) LLC 1, a purported promissory note of $2.7 million; (2) LLC 2, a purported promissory note of $2.7 million; and (3) LLC 3, a purported promissory note of $1 million. Nevertheless, the notes were *not* secured nor collateralized and no repayments were ever made. LLC 2 and LLC 3 secured third-party financing but neither LLC1 nor the taxpayer or his wife were personally liable for the debt, were a guarantor of the debt, or pledged any of their assets as collateral or security for the debt. In spite of all the questions concerning whether these promissory notes were valid, the taxpayer still try to claim deductions for net operating losses of $3.5 million, $3.3 million, and $3.2 million that had flowed through on his respective K-1s. The IRS and Tax Court agreed that neither the taxpayer nor his wife acquired any basis in LLC 1, LLC 2, or LLC 3 (i.e., under **Code §752(a)**, along with the fact that he was not at-risk (i.e., under **Code §465**). As a result, the passthrough losses could not be claimed on his personal return until such time that he could establish that had sufficient at-risk basis to cover these NOLs. (**Code §752(a)**; **At-risk Basis**)

Code §754 - Sec. 754 Step-up Election:

☞**IRS Provides Procedures for Revoking Sec. 754 Election**

The IRS has provided its employees with updated **procedures** to use when determining whether to approve or deny a partnership's request to revoke its **Code §754** election to adjust partnership property basis. Furthermore, this guidance applies to any partnership, whether subject to **TEFRA**, the **BBA**, or separate deficiency proceedings.

> **Sec. 754 Election:** A partnership may elect to adjust the basis of its property after:

1. A distribution of partnership property, or

2. Certain transfers of a partnership interest.

To make the election, a partnership must attach a statement to the partnership's timely-filed return (including extensions) for the tax year in which a distribution or transfer occurs. The statement must include:

1. The name and address of the partnership, and

2. A declaration that the partnership is making a **Code §754 election**.

Once this election is made, it applies to *all* distributions and transfers made during the tax year for which the election is initially filed, and to *all* such transactions in any subsequent tax year unless the election is revoked. This election can only be revoked with permission of the IRS Commissioner. (**IRS.gov/Sec. 754 FAQs**)

Sec. 754 Revocations: A partnership that wants to revoke its **Code §754** election should file its revocation request using **Form 15254, Request for Section 754 Revocation**, no later than 30 days after the close of the partnership's tax year. **Form 15254** must state the reason(s) for requesting a revocation. The regulations provide examples of situations that may warrant the IRS approving a partnership's revocation application. (**Reg §1.754-1(c)**)

These examples include:

1. A change in the nature of the partnership's business;

2. A "substantial increase" in the partnership's assets;

3. A "change in the character" of the partnership's assets; or

4. An "increased frequency" of retirements or shifts of partnership interests.

A revocation application will *not* be approved when the revocation's purpose is primarily to avoid a reduction in the basis of partnership assets upon a transfer or distribution of partnership property.

> **Comment:** Taxpayers used to employ a deliberate "technical termination" (i.e., more than 50% change in particular partner's interest within a 12-month period) to achieve the same result, namely the revocation of a Sec. 754 election previously made. But, with the passage of the **TCJA**, this was no longer possible since "technical terminations" have been eliminated in the tax law. Moreover, as stated above, the IRS will *not* approve such revocations in those situations where it would be most common (i.e., when the revocation's purpose is primarily to avoid a reduction in the basis of partnership assets upon a transfer or distribution of partnership property).

In addition, the IRS has updated procedures for reviewing revocation application requests on **Form 15254**. These procedures cover:

- Processing the **Form 15254**
- Making the determination to approve or reject the revocation request
- Getting managerial approval of the determination
- Sending the recommended determination to Chief Counsel for review
- Obtaining the proper signatures for the determination letter, and
- Document retention procedures. (**Code §754; Sec. 754 Elections**)

☞**IRS Issues Final Regs on Signature Removal for Sec. 754 Election (TD 9963)**

The IRS has issued final rules on how to make a valid election to adjust the basis of partnership property after the partnership makes a property distribution or a partnership interest is transferred. Under **Code §754**, after a partnership makes a distribution of partnership property, or an interest in the partnership is transferred, the partnership may make an election to adjust the basis of the remaining partnership property. Generally, a partnership makes a basis adjustment election in a written statement that's filed with the partnership's return for the year of the distribution or transfer. Proposed regulations

(**REG-116256-17**) removed the partner signature requirement for a valid election under **Reg. §1.754-1(b)**. These final regulations adopted the October 2017 proposed regulations without change for tax years ending on or after 8/5/2022. **(Code §754; Sec. 754 Election)**

☞**Bonus Depreciation and Code §754 Step-ups to Partnership Assets**

Bonus depreciation, now set at 100% through 2022, is permitted on *both* tangible personal and real property having a MACRS classlife of 20 years or less. It is not, however, allowed for intangible assets such as goodwill which must instead be amortized over 180-months pursuant to **Code §197** (commencing with the month that the asset is first placed in service).

> **Comment:** In the **CARES Act**, Congress has passed a technical corrections bill which, among other items, clarifies that "qualified improvement property" (QIP) is indeed included in the MACRS 15-year class and, therefore, eligible for bonus depreciation. And this clarification states that it is *retroactively* effective as of 1/1/118.

Before 9/28/17, "used" assets were *not* eligible for bonus depreciation (which was set at a rate of 50% at that time). Instead, the "original use" of the asset had to have commenced with the taxpayer seeking to claim bonus depreciation (and, this would include lessees who decided to purchase the asset at the end of the rental period, such as a vehicle or equipment, so long as the lessee was the *first* (i.e., "original") taxpayer to have ever used the property in question).

With the passage of the **TCJA**, however, the *outright purchase* of *previously-used* assets is now permitted when claiming bonus depreciation. But, what about the "deemed acquisition of assets" where a partnership interest was transferred in a taxable sale or exchange? Under the "aggregate theory" of partnership taxation, the entity's owners are treated as possessing an indirect interest in each and every one of the assets that the partnership has on its balance sheet. So, has not the purchaser of a partnership interest essentially bought the selling partner's underlying share of their right to each and every one of the entity's assets? And, if so, how does that impact the use of bonus depreciation on the assets (or, portion thereof with regard to a "step-up in basis") deemed purchased?

Furthermore, where a partnership asset is distributed under the provisions of **Code §731** and the distributee partner has insufficient basis to absorb the basis that the entity had in that asset (i.e., since their "outside basis" is less than what the "inside basis" of the asset was to the partnership), can this "disappearing basis" be used to step-up the bases of the remaining assets that the partnership has and be treated as "qualified property" for which bonus depreciation can be claimed? Or, if cash or marketable securities are distributed to a partner in the liquidation of their interest and their FMV of the assets received exceeds the partner's basis in their interest, thereby resulting in gain recognition, can the bases of the assets that partnership still holds be stepped up?

The Treasury issued proposed regs in August, 2018 (Cf. **REG-104397-18**) which address the bonus depreciation rules and how they apply to "qualified property" acquired and placed in service after 9/27/17. Although these proposed regs are technically *not* effective until finalized, they can be relied upon in the meanwhile. More importantly, they do serve to clarify that **Code §743** step-ups in partnership assets are to be treated as if additional "qualified property" (i.e., at least for those MACRS assets, both real and personal, which have a recovery period of 20 years or less) has been acquired for purposes of the 100% bonus depreciation rules.

Step-ups Under Code §743: The bottom line is that purchases of assets (or, ownership interests in assets, such as with a partnership) that result in the recognition of gain by the seller (including partners) are generally eligible for bonus depreciation due to the changes made by the **TCJA** (i.e., namely the elimination of the "original use" requirement), so long as the purchaser is *not* considered to be a "prior user" of that *same* property. On the other hand, purchases that generally do *not* result in recognition of gain by the seller are *not* treated as "qualified property" otherwise eligible for bonus depreciation. Also eligible for bonus depreciation would be Sec. 754 step-ups where a partnership interest is inherited and some of the assets stepped up within the entity are otherwise qualify for bonus depreciation (i.e., they have a MACRS class-life of 20 years or less).

These proposed regs provide guidance on how the new bonus depreciation rules will apply to a wide variety of transactions involving partnerships (and, disregarded entities) holding assets for which bonus depreciation may be claimed (unless the taxpayer elects out of taking this immediate write-off). More importantly, all of the facts and circumstances should be evaluated to determine the appropriate treatment of a given transactions. But, set out below are the general guidelines for the most typical situations.

1. If an existing interest in an partnership is purchased directly from a partner, and an election is in effect under **Code §754** to adjust the purchaser's share of the "inside bases" of the partnership's assets equal to the "outside basis" paid pursuant to **Code §743**, bonus depreciation will be available for the purchasing partner's **corresponding increase in the stepped-up portion of the assets deemed acquired**.

2. If one of the owners of an existing multi-member LLC (or, partnership) decides to acquire all of the interests owned by the remaining members (or, partners), so that the entity becomes "disregarded" for income (but, *not* necessarily for employment) tax purposes, the owner of this SMLLC may be entitled to bonus depreciation for the portion of the assets that were deemed acquired when the other owners were bought out (Cf. **Rev. Rul. 99-6**).

> **Example: "LLC Member Buys Out All Remaining LLC Interests"**
> As of 1/1/19, A buys out the interests of B and C with regard to the ABC, LLC for $600,000. This results in the former entity now being treated as a SMLLC. Assumed that the only asset that the former LLC held was building which was used as a gas station/convenience store with an adjusted basis of $600,000 and a FMV of $900,000 which was properly classified as a MACRS 15-year asset.
>
> A already owned the one-third of the building with a basis of $200,000 and would continue the *same* MACRS recovery period and method for this portion of the building on the **Form 4562** that will now be filed on a **Schedule E** on his personal tax return.
>
> As to the other two-thirds of the building deemed purchased, A is treated as having paid $600,000 which, under **Code §1012**, would give him an initial basis equal to the cost paid for the asset. And, even though this was a "used" asset as of the time that it is now being purchased, bonus depreciation could be taken for this entire $600,000 acquisition cost.

3. If all of the interests in an existing partnership are purchased by a single unrelated outside third-party (i.e., who is currently *not* a partner or an LLC member, and has never been so), the partnership/LLC becomes a "disregarded entity" with the transaction being treated for tax purposes as an *outright purchase* of the entity's assets. As a result, these "used" assets are eligible for bonus depreciation.

> **Comment:** This is one example of where the purchase of a "partnership interest" potentially meets the definition of "qualified replacement property" for purposes of the like-kind exchange rules under **Code §1031**. For example, real estate assets are exchanged after 2017 with the proceeds deposited in an escrow account held by a qualified intermediary who then purchases all of the

interests held by partners in a partnership holding only real estate assets as well. As stated above, this is treated as if an *outright purchase* of real estate (i.e., a qualifying replacement type of asset) was in fact made. "Tenant-in-common" (TIC) interests, if the prescribed requirements set out in **Rev. Proc. 2002-22** are met, can also be treated as an *outright purchase* of the underlying assets represented by these interests.

4. If all of the ownership interest in a SMLLC is purchase, then this too can be treated as an outright purchase of the assets held by this disregarded entity, thus potentially qualifying their cost for bonus depreciation.

5. If, on the other hand, only part of the SMLLC owner's interest in this disregarded entity are purchased (thus effectively converting the entity into an LLC treated as a partnership), the availability of bonus depreciation will depend on how the transaction was structured as follows:

a. If the interest was acquired in exchange for money or property that is either transferred directly to the current owner of the SMLLC, or is contributed to the entity and subsequently distributed to this current owner (i.e., it essentially is a "disguised sale"), the transaction will be treated as an *outright purchase* of the entity's asset's with the bases being equal to the FMV of the consideration paid. Then, the asset's are deemed transferred to a new partnership/LLC with bonus depreciation being available as if the assets were purchased directly from the "old" partnership/LLC.

b. If the cash or property contributed to the SMLLC is *not* distributed out to its owner, the transaction is treated as if a new partnership/LLC was formed first, followed by a contribution of the money (or, property) in exchange for a partnership interest (i.e., governed by **Code §721** as a tax-deferred exchange, and with **Code §722** and **723** controlling the basis determination to both the entering partner (i.e., "substituted basis"), as well as the partnership (i.e., "carryover basis").

Comment: Although the new partner/LLC member might get special allocations of other depreciation benefits under **Code §704(c)**, bonus depreciation will *not* be available for their share of any of the entity's depreciable assets (since no property was actually, or deemed, "purchased" as a result of the transaction).

For example, under one of the permissible methods under **Code §704(c)** (i.e., the "remedial method"), the investing partner's allocable share of depreciation on existing assets is calculated by reference to "any" recovery period and depreciation method available to the partnership for newly-purchased property. But, the language in the proposed regs clarifies that bonus depreciation would *not* be available in making this allocation under **Code §704(c)** to the contributing partner who, as a large cash investor, might otherwise be allocated a significant initial year deduction.

In the situation where the owner of a SMLLC only has part of their interest in the entity purchased by a third-party, and thus the entity becomes a partnership for tax purposes, the proposed regs make it clear that bonus depreciation will *not* apply to any of the "rollover basis" that the original owner might have had in the entity's assets. In essence, the regs treat the assets being transferred over to this new entity (i.e., the partnership, now that there are two or more owners) as being "previously used" by the original owner of the SMLLC. But, the purchaser who is treated as having acquired a share of the former SMLLC's assets (i.e., when the "single LLC member's interest" was partially bought out) which are then deemed contributed to the new partnership entity would, if a **Code §754** election was in effect, be eligible to claim bonus depreciation on this stepped-up portion of the asset's inside basis to the entity.

Step-ups Under Code §734(b): Where distributions of cash or securities results in gain being recognized by a distributee partner (i.e., since the FMV of the property distributed exceeds the partner's basis in their interest), this might result in a step-up pursuant to **Code §734(b)** to the entity's remaining assets, given an election under **Code §754** is in effect. Nevertheless, under the theory that this step-up relates to assets "previously used" by the partnership, the proposed regs make it clear that bonus depreciation is *not* available in such situations (despite the fact that gain was recognized by the distributee partner).

If the partnership distributes property, either as a current or liquidating distribution to a partner, the partner may be required to step-up (or, step-down) the basis in the property received. Again, in this situation, the proposed regs deny the use of any bonus depreciation on the "stepped-up portion" for the property received.

Aggregate v. Entity Theory: The above discussion centers predominantly around the concept that a partnership is nothing more than a "transparent aggregation of its owners" with regard to the assets which the entity otherwise holds. Thus, purchases of a partner's interest in the entity can in fact be treated as "deemed purchases" of the entity's underlying assets. On the other hand, an S corporation though possessing many of the same characteristics of a partnership, is governed by the "entity theory" of taxation. As a result, many of the transactions mentioned above would *not* be treated as a purchase of the S corp's assets when a shareholder sells their stock.

The only exception would be a "deemed asset sale" where the seller of S corp stock agreed to make an election under **Code §338(h)(10)** to instead treat the sale of their stock as if it were a sale of the corporation's assets. The basic requirement for this type of transaction is that the purchaser be a corporation (e.g., an LLC electing to be treated as an S corporation) which is infused with the cash that an individual purchaser would have used to make the acquisition (i.e., under **Code §351**) and that 100% of the target S corp's stock be acquired within a 12-month period so that a QSUB election can be made and the acquiring S corp therefore becomes an eligible shareholder.

Since this would be deemed as an "asset purchase" where the inside bases of the target's assets would be stepped-up to the FMV of the consideration paid for the S corp stock, this *total* amount for otherwise "qualified property" would be eligible for bonus depreciation (let alone, **Code §179** immediate expensing). To be clear, unlike a step-up under **Code §754**, the *entire* amount of the stock purchase price would be eligible for bonus depreciation on any "qualified property" deemed acquired. Assets such as goodwill, however, would have to instead be amortized. And, if the S corp target had been on the cash basis of accounting, a reasonable allocation of the stock's purchase price would have accorded to any outstanding accounts receivable (or, inventory, if instead on the accrual method). **(Code §168(k); Bonus Depreciation)**

> **Comment:** Stock purchases of an S corp's QSUB stock could also be treated as a "deemed asset purchase" if an election was made under **Code §336(e)**. Furthermore, the purchaser could be an individual and not necessarily a corporation (as is the case with an election under **Code §338(h)(10)**).

Code §1250 - Depreciation Recapture:

☞**Unrecaptured §1250 Gain Treatment Avoided on Liquidating Distributions Made Out of Real Estate LLCs**

Consider a situation where a member of an LLC holding appreciated real estate decides to sell out their interest to an unrelated third party. To the extent that there is any gain due to straight-line depreciation, this will be considered "unrecaptured Sec. 1250 gain" which is taxed at 25%. And, this gain, along with any other Sec. 1231 gain on the property, would flow from Form 4797 to Schedule D. Basically, the rule is that the normal capital gains treatment accorded by **Code §741** is negated by the "hot asset" rules of **Code §751**. Surprisingly, there is a different answer where this partner or LLC member has their interest terminated by receiving a liquidating distribution from the entity itself. **Reg.§1.1(h)-1(b)**, (which deals with the appropriate tax rates in various situations) indicates that the 25% rate does *not* come into play, as well as the **Code §751** "hot asset" rules *not* being imposed, where the interest is *redeemed* instead of being sold to an outside third party. As a result, the exiting partner receives Sec. 1231 treatment on the *entire* gain, and absent any Sec. 1231 losses for the current year (or prior 5 years that have *not* otherwise been recaptured), this entire gain would flow to Schedule D. **(Code §1(h); Unrecaptured Sec. 1250 Gain)**

Comment: If the real estate market was depressed in some areas of the country, it might not be unusual to see LLC members wanting to perhaps cash out of their ownership interests. By having the entity refinance their real estate holdings and redeem this member's interest, they will be able to exit with capital gains treatment (vs. certain 25% unrecaptured Sec. 1250 gain). Of course, the remaining members of the LLC would then be stuck with this exiting member's share of 25% gain when they sold their respective interests (or, just had the entity sell the property with the proceeds being passed out on the dissolution of the entity).

Code §6103 - Return Disclosure:

☞**Partners Entitled to Receive Partnership Administrative File Records**

The IRS's **Privacy, Governmental Liaison and Disclosure** division issued guidance that says that partner(s) (or, a partnership representative) are entitled to request and receive administrative file record(s) containing partnership returns and return information. This memo also states that **Code §6103(e)(10)** (i.e., limitation on certain disclosures to persons having a material interest) does *not* apply to such a request.

Background - Return Disclosure: The Code provides that, in the case of a partnership return, the return of a partnership must, upon written request, be open to inspection by, or disclosure to, *any* person who was a member of such partnership during *any* part of the period covered by the return. (**Code §6103(e)(1)(C)**) But the disclosure of partnership returns is also limited by the provisions of **Code §6103(e)(10)** which provides that, in the case of an inspection or disclosure under **Code §6103(e)** (i.e., relating to the return of a partnership, S corporation, trust, or an estate), the information inspected or disclosed may *not* include any supporting schedule, attachment, or list which includes the taxpayer identity information of a person other than the entity making the return or the person conducting the inspection or to whom the disclosure is made.

Disclosures of returns and return information subject to **Code §6103(e)** (i.e., disclosure to persons having a "material interest") can also be made under the **Freedom of Information Act (FOIA)**, as well as pursuant to **Reg. §301.9000-1** through **Reg. §301.9000-7** (i.e., "other disclosure methods").

An "IRS administrative file" is a return and/or other documents such as work papers, schedules, audit reports, etc., that are related to a taxpayer's account regardless of whether the documents are physically with the return or maintained separately by IRS. (**IRM 3.5.61.1.8(1)**)

Background - Partnership Audits: The **Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)** created procedures which require that an examination of any partnership items be handled in one partnership-level proceeding and *not* at the partner level. This "TEFRA process" generally applies to tax years *prior* to 2018. TEFRA also created the Tax Matters Partner (TMP) who is the primary contact during a TEFRA examination.

Sec. 1101 of the **Bipartisan Budget Act of 2015 (BBA)** repealed the TEFRA partnership procedures. BBA is generally effective for tax years *after* December 31, 2017. After that date, partnerships are required to designate a "partnership representative." The partnership representative has the sole authority to act on behalf of the partnership. The partnership representative does *not* have to be a partner. Nevertheless, their actions will serve to bind the partnership and all partners of such partnership in dealings with the IRS.

IRS Guidance Regarding Disclosure Rules: This IRS memo notes that **Code §6103(e)(10)** applies to a request made for a partnership return. But it does *not* apply to a request made (i.e., by any partner or partnership representative) under the other disclosure methods discussed above (such as a FOIA request) for access to IRS administrative file record(s), pertaining to a partnership. As a result, partner(s) or a partnership representative are entitled to request and receive administrative file record(s) containing partnership returns and return information. **Code §6103(e)(10)** does *not* apply to these requests. **(Code §6103; Return Disclosure)**

Code §6229 - Statute of Limitations:

☞**Statute of Limitations for IRS Assessment of Tax Expired (*American Milling, LP*, TC Memo 2023-83 (6/29/2023))**

The Tax Court held that the period of limitations for assessing tax attributable to partnership items had expired. The taxpayer engaged in a series of transactions constituting a "Son-of-BOSS tax shelter" (i.e., designed to reduce capital gains from the sale of a business or appreciated assets). Multiple entities were formed to facilitate the transaction in which the taxpayer was an indirect partner. The IRS determined and the U.S. District Court for the Southern District of Illinois upheld that the transactions "lacked economic substance" and that corresponding tax adjustments should be made. But none of the **Forms 1065** filed by the partnerships listed the taxpayer "as a direct or indirect partner." The IRS countered that **Code §6229(e)** kept the statute of limitations period open but the Tax Court concluded that the adjustments were *not* timely made and the period of limitations for assessment against the taxpayer had in fact passed. **(Code §6229; Tax Assessments)**

☞**Faxed Form 1065 Satisfied IRS Filing Requirement (*Seaview Trading, LLC*, No. 20-72416 (9th Cir., 5/11/2022))**

Faxing a copy of a late partnership return to an IRS agent was treating as filing a return, according to the 9th Circuit Court of Appeals. This decision *reversed* the Tax Court which held that the firm never filed its 2001 return because it failed to send the document directly to the IRS service center. In this instance, an IRS agent notified the firm in 2005 that the Service had never received the **Form 1065** for the 2001 tax year. The partnership then faxed a copy of it to the agent, who began an audit of the return. In 2010, the agent sent the firm a notice of adjustment. The firm claimed the notice was invalid because it was issued *over three years after* the company filed its return with the agent. The 9th Circuit concluded that a delinquent partnership return should be treated as filed "when an IRS official asks for it, the partnership delivers it and the official receives it." **(Code §6229; SOL)**

Code §6501 - Limitations on Assessment and Collection:

☞**Individuals' SOL Extension Also Extended Assessment Date for Their Partnership Income (*Inman Partners*, TC Memo 2018-114 (7/23/2018))**

The Tax Court confirmed that, where several individuals who were partners in a partnership each agreed to extend the statute of limitations (SOL) on assessment for any income tax on any return made by or for them "for the period ended Dec. 31, 2000," the extension also applied to partnership items from the partnership whose tax year ended Dec. 19, 2000. **(Code §6501; Statute of Limitations)**

Code §6698 - Failure to File Partnership Return:

☞**IRS Issues FAQ Guidance on "Negative Tax Basis Capital Account" Reporting**

The IRS has issued guidance in the form of a **FAQ** on the new "negative tax basis capital account reporting requirement" added to the 2018 **Form 1065** instructions. The instructions require partnerships to report partners' "tax basis capital accounts" on **Line 20** of **Schedule K-1** if those amounts are negative at *either* the beginning or ending of the year. **Notice 2019-20** provides penalty relief for some partnerships that fail to report the amounts. The FAQ defines a partner's "tax basis capital account" and explains how it is calculated with examples, and provides a "safe harbor" that allows partnerships to calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under **Code §752** from the partner's outside basis. **(Code §722; Partner Capital Accounts)**

> **Comment:** A partner's "tax basis capital account" (sometimes referred to simply as "tax capital") represents its equity as calculated using tax principles, *not* based on GAAP, **Code §704(b)**, or other principles.
>
> > **Comment:** A partner's "tax basis capital account" can be *negative* when its outside basis is otherwise zero or positive because outside basis is increased by the partner's share of partnership liabilities under **Code §752** and the partner's tax basis capital account is *not*. A partner's tax basis capital account can also be *negative* if a partnership allocates tax losses or deductions or make distributions to the partner in excess of the partner's tax basis equity in the partnership, or when a partner contributes property subject to debt in excess of its adjusted tax basis to a partnership.
>
> **IRS Example:** At the beginning of the current tax year, A and B each contribute $100 in cash to a newly formed partnership. On the same day, the partnership borrows $800 and purchases Asset X, "qualified property" for purposes of **Code §168(k)** (i.e., bonus depreciation), for $1,000. Assume that the partnership properly allocates the $800 liability equally to A and B under **Code §752**. Immediately after the partnership acquires Asset X, both A and B have tax basis capital accounts of $100 and outside bases of $500 ($100 cash contributed, plus $400 share of partnership liabilities under **Code §752**). During the tax year, the partnership recognizes $1,000 of tax depreciation under **Code §168(k)** with respect to Asset X; the partnership allocates $500 of the tax depreciation to A and $500 of the tax depreciation to B. As of the end of the tax year, A and B both have tax basis capital accounts of negative $400 ($100 cash contributed, less $500 share of tax depreciation) and outside bases of zero ($100 cash contributed, plus $400 share of partnership liabilities under **Code §168(k)**, and less $500 of share tax depreciation).

☞**Partnerships Must Still File Returns Despite Limited Exemption from Failure-to-File Penalty (CCA 201733013)**

Normally, partnerships that fail to timely file a partnership return are subject to a failure-to-file penalty under **Code §6698** unless "reasonable cause" is shown. **Rev. Proc. 84-35** provides a limited exception to this rule for domestic partnerships with 10 or fewer individual partners if all partners report their proportionate shares of income and deductions on timely-filed returns. In this recent Chief Counsel Advice, the IRS concluded that **Rev. Proc. 84-35** does *not* provide an automatic exemption to partnerships from the actual requirement of filing Form 1065. The justification is that the IRS does *not* know how many partners are in the partnership or whether all of the partners timely filed their income tax returns unless and until the partnership (or, one of its partners) is selected for audit. **(Code §6698; Failure-to-File Penalty)**

PARTNERSHIP/LLC TAXATION - CONSULTING ISSUES:

Miscellaneous:

☞**Sale of Partnership Interest v. S Corp Stock**

Even though S corps are flowthrough entities like partnerships, they are taxed the same as C corporations when a shareholder sells their stock. In other words, unlike partnerships where you need to "look through" and ascertain each and every asset on the balance sheet that the partner owns indirectly, this is *not* required for S corp owners. Instead, they are entitled to capital gain (or, loss) treatment (which would also be eligible for **Code §453** installment sale treatment).

On the other hand, the tax treatment accorded a partner selling their interest is governed by **Code §741** which states:

> *"In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items)."*

So, initially, partners are also accorded capital gain (or, loss) treatment when they sell (or, exchange) their ownership interest. But **Code §751** "overrules" **Code §741** to the extent that, had the selling partner remained as an owner of the entity, they would have received *ordinary* income (or, loss) treatment on the sale of those particular assets (e.g., collection/factoring of cash basis receivables, sale of inventory or depreciable/amortizable assets).

Code §751 states that *"The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to (1)unrealized receivables of the partnership, or (2)inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset."*

> **Comment:** The term "unrealized receivables" in **Code §751** includes *not* only cash basis receivables but also depreciable or amortizable assets that would result in ordinary income if sold due to the "depreciation recapture" rules under **Code §1245**. And, "inventory items" no longer need to be "substantially appreciated" to come under the "hot asset" recharacterization provision of **Code §751**.

And since the sale of such assets would have resulted in ordinary income (or, loss), **Code §453(i)** installment sale treatment would *not* be available (although any gain deemed to be from other capital assets could be included in income pursuant to the terms of an installment note).

Example: "Sale of Partner's Interest in Accounting Firm"
Assume that an accounting firm had the following balance sheet and is owned by two equal partners and there are no outstanding liabilities:

Asset	Adjusted Basis	FMV
A/Rec	-0-	10,000
F&F*	-0-	2,000
Computers*	-0-	3,000
Goodwill**	-0-	85,000

*Note: The cost of these assets were immediately written off through **Code §179** or bonus depreciation.

**Note: The firm's current client base was generated through "practice development" efforts rather than the acquisition of any competing practices.

Had this partner remained and the firm was dissolved with the sale of all of its assets, the following tax consequences would result which would be shared equally by these two partners:

- Collection of cash basis receivables: 10,000
- Sale of F&F and computers: 5,000

Both of these gains would be treated as *ordinary* income whereas the sale of the firm's client base (i.e., goodwill) would be accorded *capital* gain treatment. So, the ordinary income be shared equally with $7,500 being listed as "Other Income" on each partner's K-1. The $42,500 of gain on the goodwill be listed as a capital asset gain on their K-1s.

Comment: The capital gain from the sale of goodwill would *not* be a Sec. 1231 gain since even though it was a "trade or business asset" and held long-term, it was neither amortizable or depreciation (i.e., one of the three requirements under **Code §1231** in order for the gain to be reported on **Form 4797** as opposed to directly on **Schedule D**).

This example emphasizes that exactly the *same* tax result should occur if one of the partners were to instead sell their interest in the firm (i.e., instead of the firm being dissolved and sold) at a time that their basis in their partnership interest was zero. Assume that one partner sold their interest for $50,000 with $10,000 as a down payment and $10,000/year over the next four years. The first $7,500 of gain (i.e., allocable to the partner's share of ordinary income assets) would have to be included in income *immediately* (regardless of any down payment received). The remaining $40,000 of gain, however, would be recognized over the four-year installment period.

Comment: The guiding principle in this summary is that "you shouldn't get a different result had you owned the assets in question directly (i.e., for example, in a **Schedule C** proprietorship), or instead sold their indirect interest in assets owned as a partner in a partnership." Comparing the two separate tax results really helps to see how the "hot asset" rules under **Code §751** should work.

Example: "Sale of Partner's Interest in LLC Holding Real Estate"
Assume an LLC owned by two equal partners owns a commercial building that had no outstanding debt on it (i.e., mortgage). It was purchased several years ago for $200,000, but due to S/L depreciation it now has an adjusted basis of $100,000. Its current FMV is $400,000 and is going

to be sold in the current tax year.

Since it is a Sec. 1231 asset, the sale would be reported on **Form 4797**. The $300,000 gain is split between the $100,000 of "unrecaptured §1250 gain" with the remaining $200,000 (i.e., due to the underlying appreciation of the building from its original cost of $200,000 to its current FMV of $400,000) being treated as Sec. 1231 gain.

Both types of gain would initially be shown as separately stated items on the partners' K-1s and be reported on their **Form 4797** and then would flow over to the **Schedule D** worksheet (i.e., **Form 8949**) where the total $300,000 gain could be used to offset any capital losses. The net amount would finally be shown on **Schedule D**.

What would happen if instead one of the partners were to sell their interest? Assume that the building was used as collateral by the LLC for a loan with the $200,000 proceeds (i.e., one-half of the current FMV of $400,000) being used as a liquidating distribution (or, this partner could have easily sold their interest to an unrelated third-party). If the partner had a basis of $50,000 (i.e., one-half of the current adjusted basis of the building) in their partnership interest, the resulting gain would be $150,000. This gain would again be divided between the $50,000 of "unrecaptured §1250 gain" with the remaining $100,000 of §1231 gain.

Comment: As with the example above, both types of gain flow from the **Form 4797** over to **Form 8949** and finally to **Schedule D**. The curious thing here is that there is a distinction between the partner selling their interest to an unrelated third-party v. a liquidating distribution being made to extinguish their interest. The former option would result in the two types of gain, whereas the latter approach would yield *all* LTCG. In other words, with the liquidating distribution, the "unrecaptured §1250 gain" would stay with the building and would only be recognized when the building itself was ever sold by the LLC.

Comment: If the building was ever sold on an installment basis, both types of gain would qualify (i.e., since there would be no "ordinary income" portion attributable to the sale). But the "unrecaptured §1250 gain" would have to be included in income first, with the §1231 gain being picked up thereafter.

Notes:

C CORPORATIONS:

Miscellaneous:

☞**Changes to Schedule UTP "Uncertain Tax Positions" Reporting**

Schedule UTP (Uncertain Tax Position Statement) is filed with **Form 1120**, **Form 1120-F**, **Form 1120-L**, or **Form 1120-PC** to report "uncertain tax positions." The form must be filed if total assets equal or exceed the "applicable asset threshold" for the tax year *and* the corporation records a liability for unrecognized tax benefits for a U.S. federal income tax position in audited financial statements. Changes to the schedule include a *new* field for the "incremental dollar amount" of the uncertain tax positions taken and *new* columns for identifying the rulings or regulations "that are contrary to positions taken on the tax return." Additionally, the revised **Schedule UTP** instructions "incorporate more relevant examples and provide enhanced guidance on what constitutes an adequate disclosure for the concise description." **(Misc.; Schedule UTP)**

> **Comment:** The requirement that is more common, especially if we are dealing with a client that does *not* have audited financial statements, is the use of either **Form 8275** or **Form 8275-R** where a position taken on the tax return is disclosed to the IRS so as to hopefully avoid client and preparer penalties.

Code §61 - Gross Income:

☞**Yet Another Case Where Advances from Family Business Were Additional Compensation and Not Loans (*Caiping Zang and Tao Liu,* TC Memo 2017-55 (4/3/2017))**

The Tax Court has upheld the IRS's determination that these married taxpayers had unreported income for three years, including wages, rental income, gambling income, along with significant advances from a company of which they were sole officers and which was controlled by the husband's father. The Court rejected their claim that the advances were loans, finding that there were no indications at the time the funds were advanced that "the parties intended to create a bona fide debtor-lender relationship."

As demonstrated in numerous cases to-date on this issue, in determining whether a bona fide loan exists between a company and its owner, the Tax Court considers:

1. The ability of the borrower to repay;
2. The existence or nonexistence of a debt instrument;
3. Security, interest, a fixed repayment debt, and a repayment schedule;
4. How the parties' records and conduct reflect the transaction;
5. Whether the borrower has actually made repayments;
6. Whether the lender had demanded repayment;
7. The likelihood that the loans were disguised compensation for services; and
8. The testimony of the purported borrower and lender.

> **Comment:** Look to the Tax Court's decision in ***Kaider,* TC Memo 2011-174 (7/20/2011)** which also provides an excellent overview and discussion of these factors. **(Code §61; Company Loans)**

Code §162 - Trade or Business Expenses:

☞**Unreasonable Rent Recharacterized as Constructive Dividend (*Plentywood Drug,* TC Memo.**

2021-45 (4/26/21))

The IRS is placing an increased focus on related-party transactions with closely-held corporations. For instance, this case involved rent paid by a company to its shareholders. The corporation operated a drugstore in a small town in Montana and paid $192,000 in annual rent to lease space in a building owned by the firm's shareholders. When audited, the IRS argued the rental value to the corporation was only $60,000 and recharacterized the excess as a nondeductible constructive dividend. The Tax Court then reviewed expert testimony provided by each party and concluded that the annual fair rental value was $171,000, which was much closer to the taxpayer's figure than that of the IRS. **(Code §162; Related Parties)**

> **Comment:** With the flat 21% C corporation rate introduced by the **TCJA**, how much of a tax impact occurs when a deductible expense such as rents or wages is reclassified instead to being a dividend?

Code §311 - Property Distributions:

Treatment of Property Distribution Dividends to Shareholders (T.D. 9954)

The IRS has issued final regulations updating the existing regulations under **Code §301**, to reflect the statutory changes made by the **Technical and Miscellaneous Revenue Act of 1988**. These changes provide that the amount of a distribution of property made by a corporation to its shareholder is the fair market value of the distributed property (i.e., as provided for under **Code §311**) as of the date that the distribution is actually made. Proposed regulations (**REG-121694-16**), published in March 2019, were limited to (1) deleting provisions made obsolete by statutory changes; (2) making minor additions and revisions to reflect current statutory text; and (3) making nonsubstantive changes for purposes of clarity and readability, including reordering and redesignating paragraphs of the current regulations. The final regulations adopt the 2019 proposed regulations "with no substantive changes and certain nonsubstantive changes for purposes of clarity and readability." **(Code §301; Property Distributions)**

> **Comment:** **Code §311(b)** is one of the more powerful tax provisions in the IRC. It is what creates the "double taxation" dilemma when trying to get appreciated property out of a C or S corporation. As a result, even the mere transfer (i.e., nonliquidating distribution) of title from the corporation to a shareholder of appreciated property (e.g., real estate) is treated as a deemed sale with the entity having to pay the underlying tax.

Code §331 - Accumulated Earnings Tax:

☞Is Accumulated Earnings Tax Penalty Making a Comeback?

Recently, there has been some concern as to whether the low corporate tax rate is triggering more accumulated-earnings-tax audits? Apparently, that might indeed be the case as we are currently seeing an increase in such audits. The **TCJA** lowered the C corporation tax rate to a flat 21%. And, arguably, this low rate, when compared with the 37% top individual marginal rate, makes C corp status beneficial, especially for those companies that retain earnings rather than pay dividends to their owners.

The accumulated earnings tax penalty rate is 20% (i.e., the highest rate on dividends) of earnings accumulated in excess of the *larger* of $250,000 or accumulations needed for "reasonable business needs" (RBNs), such as growth of the firm, debt retirement, shoring up the firm's pension plan or covering the loss of a principal customer. The minimum accumulation allowed for service corporations is $150,000. Firms with excess accumulated earnings and a history of *not* paying dividends, or paying small dividends, could face increased IRS audit exposure.

Clients should be advised to document the business purpose (i.e., RBNs) for accumulating earnings by including a description of the plans and decision-making processes in the corporate minutes and budget forecasting documents, to the extent that significant funds are set aside for such purposes. **(Code §531; AET Penalty)**

Code §351 - Capital Contributions:

☞**Chief Counsel Warns IRS Auditors to Be Aware of "Capital Asset Holding Period Tricks" (AM 2020-005)**

The IRS Chief Counsel office has issued guidance on the effect on a sole shareholder's holding period in corporate stock when the shareholder makes a transfer of money or other property to the corporation for no consideration (i.e., what the IRS terms a "meaningless gesture transaction" such as where the shareholder already owns 100% of the outstanding stock). This memo recommends that the IRS challenge transactions in which a shareholder's purported holding period in the stock of a wholly-owned corporation does *not* take into account the effect of these "meaningless gesture transactions."

Background: Code §351(a) provides that a person does *not* recognize any gain or loss if the person transfers property to a corporation solely in exchange for stock in the corporation and immediately after the exchange the person is in control (i.e., ≥ 80% as defined in **Code §368(c)**) of the corporation. In general, a "capital asset" is an asset held by a taxpayer (whether or *not* used in a trade or business) other than inventory, depreciable or amortizable assets, receivables, and other certain assets. (**Code §1221(a)**)

If the taxpayer holds a capital asset for *one year or less* (i.e., a "short term" holding period), the gain or loss from its sale or exchange is treated as a short-term gain or loss. (**Code §1221(1)**) If the taxpayer holds a capital asset for *more than one year* (i.e., a "long term" holding period), the gain or loss from its sale or exchange is treated as a long-term gain or loss. (**Code §1221(3)**) Long-term capital gains are generally taxed at a lower rate (i.e., 0%, 10%, 12%, 15% or 20%) than short-term capital gains (which are taxed at ordinary marginal tax rates). (**Code §§1(a) &(h)**)

IRS Issue and Fact Patterns: If a shareholder owns all the stock of a corporation, how does a transfer of money or other property (i.e., a capital contribution) by the shareholder to the corporation for no consideration (according to the IRS, a "meaningless gesture transaction") affect the shareholder's holding period in the corporation's stock? Is that transfer subject to **Code §351(a)**?

> **Comment:** While the IRS uses the phrase "meaningless gesture transaction," the contribution of money and property to a corporation by its sole shareholder (i.e., a capital contribution) is arguably *not* meaningless in the sense that the corporation will use those assets to pay bills, buy inventory or additional assets, etc.

In each of the following situations, on January 1, Year 1, an individual ("Shareholder") contributes property with negligible value to a newly-formed domestic corporation ("Corporation"), in exchange for all of Corporation's stock (the "initial transfer"). The initial transfer was a tax-free exchange under **Code §351**.

Assume that: (1) all shares of stock issued to Shareholder are capital assets in Shareholder's hands; (2) that no transfer to Corporation is subject to the **Code §351(d)** rules regarding transfers of stock in return for services, certain indebtedness, or accrued interest; (3) that no transfer to the Corporation is subject to the **Code §351(e)** rules regarding transfers of property to an investment company or transfers by a debtor under the bankruptcy rules; and (4) that **Code §351(g)** (i.e., related to nonqualified preferred stock) does *not* apply to any stock of Corporation.

Situation 1: On August 1, Year 1, Shareholder transfers a substantial amount of money to Corporation for no additional consideration or stock in the company, and the Corporation invests the money in property that appreciates in value. On February 1, Year 2 (i.e., 6 months later), Shareholder sells all of the stock in Corporation for a price that reflects the unrealized appreciation in the property, so that gain is recognized to Shareholder. Shareholder attempts to claim that all of the stock has a holding period exceeding one year (from January 1, Year 1).

Situation 2: On March 1, Year 1, Shareholder invests a substantial amount of money in property that appreciates in value. On August 1, Year 1 (i.e., 5 months later), Shareholder transfers the appreciated property to Corporation for no additional consideration or stock in the company. On February 1, Year 2 (i.e., 11 months after the initial purchase), Shareholder sells all of the stock in Corporation for a price that reflects the unrealized appreciation in the property, so that gain is recognized to Shareholder. Shareholder attempts to claim that all the stock has a holding period exceeding one year (from January 1, Year 1).

IRS Analysis: In both Situation 1 and Situation 2, the subsequent transaction is subject to **Code §351(a)** even though the Shareholder did *not* receive any additional stock. But, according to this IRS guidance, after the subsequent transfer in each Situation, Shareholder's stock in Corporation has a “split basis” and a “split holding period” to reflect the initial transfer and the subsequent transfer. In both situations, the split basis and split holding period of Shareholder's stock “now reflects the true economics of the transactions.” After the subsequent transfer in each of the situations, a portion of the value of each share is attributable to the value added by the subsequent transfer, and the basis of Shareholder's stock includes the transferred money or the basis of the transferred property.

Including the amount of the money or the basis of the transferred property in the stock's basis without a corresponding adjustment to the stock's holding period “would be inconsistent with the principle that the holding period of property tracks the sources of the property's basis.” As a result, in **Situation 1**, the portion of each share attributable to the money transferred in the subsequent transfer has basis equal to the amount of the money and a holding period dating from the subsequent transfer. In **Situation 2**, the basis and holding period of the portion of each share attributable to the property transferred in the subsequent transfer are determined by referring to that property. Thus, in *both* situations, to the extent attributable to the subsequent transfer, Shareholder's stock has a holding period less than one year at the time of the sale of the stock on February 1, Year 2. The gain attributable to the sale of this portion of the Corporation stock is short-term capital gain.

Applicability of IRS Analysis to Other Situations: This IRS analysis states that both situations illustrate two “common forms of transactions” that are being recommended to taxpayers “as a means of artificially extending holding periods.” It also notes that the same analysis could apply if the facts were the same as above, except for one or more of the following changes:

- Shareholder is *not* an individual;

- Corporation is not a domestic corporation;

- The relative values of the initial transfer and the subsequent transfer are different from those described in Situations 1 and 2;

- Stock of Corporation is issued in the subsequent transfer, but the value of such stock does *not* reflect the value of the money or property transferred to it in the subsequent transfer;

- Shareholder is *not* the sole shareholder of Corporation, but the relationship between Shareholder and other shareholders is such that the subsequent transfer for no consideration represents compensation, a gift, or another transfer of value from Shareholder to the other shareholders; or

- Shareholder does *not* dispose of all of Corporation's stock in a single transaction.

IRS Recommendation: The IRS Chief Counsel recommends that the IRS challenge transactions in which a shareholder's purported holding period in stock of a wholly-owned corporation does *not* take into account the effect of "meaningless gesture transactions." And, depending on the facts and circumstances the IRS may challenge the transaction on other grounds as well, including that: (1) the transaction lacks economic substance; (2) that the form of the transaction does *not* correspond to its substance; or (3) that a purportedly tax-free transfer to a corporation lacks business purpose or constitutes an ineffective assignment of income or conduit transaction. **(Code §351; Corporate Transfers)**

Code §355 - Divisive Re-Orgs:

☞**"Active T/B Requirement" Temporarily Suspended for Divisive Re-Orgs (Rev. Rul. 2019-09)**

Rev. Rul. 2019-09 *suspends* two 1957 revenue rulings pending completion of a study regarding the "active conduct of a trade or business requirement" under **Code §§355(a)(1)(C)** and **(b)**. **(Code §355; Divisive Re-orgs)**

Comment: Over the years, various judicial decisions have made it clear that to take advantage of the tax-deferred "divisive re-org" provision of **Code §355**, the trade or business to be jettisoned (i.e., "spun-off") has to involve a truly active, on-going T/B and *not* simply a particular asset such as a singular parcel of real estate or building. So, with regard to the new Sec. 199A deduction, this would be one Code section where the JCT might assert that a mere rental property would *not* constitute a "trade or business activity" (even though it would be under numerous other IRC provisions such as **Code §§162, 163(j), 170, 179** and **1231**).

Code §1202 - Qualified Small Business Stock Exclusion:

☞**Qualified Small Business Stock Rules Can Convert Startup Profits into 100% Tax-Free Gains**

Venture capitalists and private equity groups are starting to take a closer look structuring startups so as to qualify under the "qualified small business stock" (QSBS) provisions of **Code §1202**. And, if they can meet these requirements, the benefits of doing so are fairly clear. This often-overlooked Code provision can convert some or all of the profit on a successful investment in a startup into tax-free gain.

Comment: The biggest problem with this QSB tax break is that it only covers C corporations. Yet arguably, over 90% of all business returns are filed as passthrough entities. Furthermore, even if a C corporation is involved, numerous types of businesses conducted by C corporations are excluded from the definition of a "qualified small business" and there are a number of other prerequisites that have to be satisfied.

Comment: This is an extremely complex area for which the IRS has failed to issue much in the way of guidance (i.e., regulations, rulings, etc.). What we have at this point is just a few rulings dealing with the health care industry, and one on an Air BnB-type website that was found to be in a "disqualified" brokerage business. And, the Tax Court has only dealt with one case thus far on **Code §1202**. Nevertheless, tax practitioners need to be aware of the basics in this area and what steps they can take to ensure that their clients might eventually qualify for this extraordinarily tax break. And, when it comes time to consider going public and selling some or all of a founder's stock, it would be wise to obtain a "substantial authority" letter from a law firm that specializes in this gain exclusion.

Background: *Noncorporate* taxpayers may exclude from gross income 100% of any gain realized on the sale or exchange of QSBS held for *more than five years* if the QSBS is acquired *after* Sept. 27, 2010 and *before* Jan. 1, 2012. This deadline was later eliminated and the 100% exclusion is what the current law provides.

The exclusion was 75% of gain realized on the sale or exchange of QSBS acquired *after* Feb. 17, 2009 and *before* Sept. 28, 2010, and 50% of gain realized on the sale or exchange of QSBS acquired *either* before Feb. 18, 2009, or after Dec. 31, 2011. But, there is a a cumulative and annual dollar limitation on how much gain may be excluded. (**Code §1202(a)(4), Code §1202(b)(1), Code §1202(b)(2)**) Previously, there was an AMT preference for a portion of gain from the sale or exchange of QSBS that was excluded from gross income for regular tax purposes under **Code §1202**. But that AMT provision no longer applies to QSBS. (**Code §1202(a)(4)(C)**)

A noncorporate taxpayer's net capital gain that is "adjusted net capital gain" is taxed at a maximum rate of 15%. And, if the adjusted net capital gain would otherwise be taxed at a rate below 22% (i.e., either 10% or 12%), it is taxed at a *zero* percent rate. (**Code §1(h)(1)(B), Code §1(h)(1)(C)**) Net capital gain attributable to "section 1202 gain" (i.e., that portion of the QSBS gain that is *not* excluded) is taxed at a maximum rate of 28%. (**Code §1(h)(1)(E), Code §1(h)(4)**) "Section 1202 gain" is the excess of: (1) the gain that would be excluded from gross income on the sale of certain QSBS under **Code §1202**, if the percentage limitations of **Code §1202(a)** did *not* apply, over (2) the gain actually excluded under **Code §1202**. (**Code §1(h)(7)**)

Qualifying as QSBS: Stock qualifies as QSBS only if it meets *all* of the following tests (**Code §1202(c), Code §1202(d)**):

(1) It must be stock in a C corporation (i.e., *not* S corp stock) originally issued after Aug. 10, '93.

Comment: As mentioned above, this might be the biggest hurdle for our clients who are almost exclusively S corps or LLCs taxed as partnerships. And, simply revoking the S election, while waiting out the 5-year holding period, would *not* suffice since (as mentioned below), as of the date the stock was issued, the corporation was a domestic C corporation (let alone, a QSB).

(2) As of the date the stock was issued, the corporation was a domestic C corporation with total gross assets of $50 million or less: (a) at all times after Aug. 9, '93, and before the stock was issued, and (b) immediately after the stock was issued. For this purpose, "gross assets" include those of any predecessor of the corporation, and all corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.

Comment: Even though the company must be relatively small when it starts out, if all the aforementioned conditions are met, the **Code §1202** exclusion is available no matter how large it might eventually grow (e.g., PayPal whose stock was purchased and issued to the individual's Roth IRA and which was worth millions when the company went public).

(3) In general, the taxpayer must have acquired the stock at its original issue (either directly or through an underwriter), either in exchange for money or other property or as pay for services (other than as an underwriter) to the corporation.

(4) During substantially all the time the taxpayer held the stock:

- The company was a C corporation;

Comment: Normally, it is not unusual for startup businesses to initially elect to be S corporations so that they can pass through to their shareholders losses that they anticipate incurring in their early years of operation. Nevertheless, the decision to make an S election should be reexamined if the shareholders anticipate taking advantage of the QSBS gain exclusion, if the S election results in the corporation *not* being a C corporation during "substantially all" of a given shareholder's holding period for the stock. Unfortunately, neither Congress nor the IRS has clarified what will be considered "substantially all" of a shareholder's holding period for this purpose.

- At least 80% of the value of the corporation's assets were used in the active conduct of one or more qualified businesses; and

- The corporation was *not* a foreign corporation, domestic international sales corporation (DISC), former DISC, regulated investment company (RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), financial asset securitization investment trust (FASIT), cooperative, or a corporation that has made (or that has a subsidiary that has made) a **Code §936** election.

Active Conduct of a Qualified Business: For purposes of the rule requiring 80% of the value of assets to be used in the conduct of a "qualified business," all of the following are treated as used in the active conduct of a qualified business:

(1) Assets used in certain activities with respect to future "qualified businesses," without regard to whether the corporation has any gross income from these activities at the time this rule is applied. Those activities are: (a) **Code §195(c)(1)(A)** start-up activities; (b) activities that result in the payment or incurrence of qualifying research and experimental expenditures under **Code §174**; and (c) activities with respect to in-house research expenses. (**Code §1202(e)(2)**)

(2) Assets held to meet the reasonably required working capital needs of a qualifying business, and assets held for investment that are reasonably expected to be used *within two years* to finance research and experimentation in a qualified business or to finance increases in working capital needs of such a business. (**Code §1202(e)(6)**) But, after the corporation has been in existence for at least two years, *no more than 50%* of its assets may qualify as being used in the active conduct of a qualified business by reason of these rules. (**Code §1202(e)(6)**)

(3) The rights to computer software which produces active business computer software royalties as defined in **Code §543(d)(1)**. (**Code §1202(e)(8)**)

A corporation will be treated as failing to meet the active business requirement for any period during which: (1) more than 10% of the value of its assets in excess of its liabilities consists of stock or securities in other corporations which are *not* subsidiaries of the corporation, other than working capital assets; or (2) more than 10% of the total value of its assets consists of real property which is *not* used in the active conduct of a qualified business (for this purpose, owning, dealing in, or renting real property is *not* considered to be the active conduct of a qualified business). (**Code §1202(e)(5)(B), Code §1202(e)(7)**) On the other hand, a corporation will be treated as meeting the active business requirement for any period during which it is a "specialized small business investment company" (SSBIC). (**Code §1202(c)(2)(B)(I)**)

Qualified Business: For QSBS purposes, a "qualified business" (even if it is a C corporation and it otherwise meets the above-mentioned conditions) is one that is *not*:

- A business involving services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services. This would include those businesses "where the skill or reputation of its owners or employees is considered to be its principal asset."

Comment: Note that this first rule is limited to service-type businesses, while the second rule, below, is *not* so limited. But, this definition of "service businesses" does extend beyond the normal definition of a PSC (i.e., as defined under **Code §444**)

- A business whose principal asset is the reputation or skill of one or more employees.

Comment: There is no other instance in which either the Code or the regs use the term "principal asset" in the context of an intangible human quality like "reputation" or "skill." And, the relevant Congressional Committee reports do *not* add any insight as to Congress' intent with respect to this language. As a result, it is quite unclear which trades or businesses will fail the "qualified business" test due to this language.

Comment: The IRS has stated that one may *not* look to the legislative regs issued for **Code §199A** in making this determination regarding "skill or reputation."

- A banking, insurance, financing, leasing, investing, or similar business.

- A farming business (including the raising or harvesting of trees).

- A business involving the production of products for which percentage depletion can be claimed.

- A business of operating a hotel, motel, restaurant, or similar business.

Comment: Given these exclusions above, it is going to be fairly difficult to qualify many of our clients' businesses for this special tax break. And, this is after the fact that the company has to be a regular C corporation to begin with.

Dollar Limit on Eligible Gain: For each tax year, for each corporation in which the taxpayer sells or exchanges QSBS, the amount of gain eligible for the exclusion is *not* permitted to exceed the *greater* of:

(1) $10 million ($5 million for married persons filing separately), less the total amount of eligible gain (i.e., gain on the sale or exchange of QSBS held for more than five years) taken into account under the **Code §1202(a)** rules by the taxpayer with respect to dispositions of stock issued by the corporation in all earlier tax years, or

(2) ten times the taxpayer's total adjusted basis in QSBS of the corporation disposed of by the taxpayer in the tax year. (**Code §1202(b)(1)**)

Other Rules: These complex QSBS requirements also include anti-abuse provisions (**Code §1202(c)(3)**), special rules for taxpayers or related parties that take certain short positions in the stock (**Code §1202(j)**), stock held by passthroughs (**Code §1202(g)**), and gifts and bequests (**Code §1202(h)**). **(Code §1202; QSB Stock)**

Comment: Surprisingly, though, original holders of QSB stock can take advantage of "**stacking and packing**" with family members and other related parties to obtain multiples of this "$10 million cap per shareholder."

Code §1221 - Capital Asset Defined:

☞**Termination Fee Paid on Failed Merger Treated as Capital Loss (CCA 202224010)**
The payment of a termination fee related to a failed merger had to be treated as a capital v. ordinary loss. A company, which agreed to acquire another corporation, paid such a fee when the transaction failed to go through. The payer had attempted to deduct the amount as an ordinary and necessary business expense (i.e., under **Code §162**). The Service instead insisted that it was a capital loss (i.e., under **Code §1221(a)(1)**) to the extent attributable to property that would have been treated as a capital asset in the taxpayer's hands, if the acquisition would have otherwise gone through. **(Code §1221; Capital Loss)**

Comment: Capital losses of corporations can offset only capital gains. Any excess is carried back for three years, with the remainder carried forward up to five years.

Notes:

S CORPORATIONS:

Miscellaneous:

☞**Letter Rulings Not Needed for Some Defective S Corp Election Requests (Rev. Proc. 2022-19)**
The IRS has issued guidance providing "taxpayer assistance procedures" which will allow S corporations and their shareholders to resolve "frequently encountered issues with certainty and without requesting a private letter ruling."

The IRS has identified issues that will *not* be treated as affecting the validity (or, continuation) of a corporation's election under **Code §1362(a)**, or to be treated as an S corporation under **Code §1361(b)(3)(B)(ii)** including its corporate subsidiary as a qualified subchapter S subsidiary (QSUB). The revenue procedure also provides "retroactive corrective relief procedures" under **Code §1362(f)** to allow taxpayers to preserve S elections that "are invalid or terminated solely as the result of one or more nonidentical governing provisions." The guidance further provides the specific areas in which the IRS will *not* rule (or, will *not* ordinarily rule), regarding the validity (or, continuation) of an S election or a QSub election.

> **Comment:** According to the IRS, this guidance is intended "to reduce burdens, facilitate increased compliance with S election and QSUB election rules, and reduce costs and delays for completing transactions involving S corporations and QSUBs."

The six areas for which issues "are resolvable without a letter ruling" are:

- The "one-class-of-stock requirement" and governing provisions, including "principal purpose" conditions; disproportionate distributions; some inadvertent errors or omissions on **Form 2553** or **Form 8869**

> **Comment:** An "inadvertent error" would include where a shareholder failed to sign the **Form 2553** S corp election.

> **Comment:** Even though a "disproportion distribution" pattern would *not* cause the revocation of the S corp election, if this was discovered for instance with a new client, they should be told to "cease and desist" paying out such amounts to only certain shareholders.

- Missing administrative acceptance letters for an S election or QSUB election

- Federal income tax return filings inconsistent with an S election or a QSub election

- Potential retroactive corrections of "nonidentical governing provisions"

> **Comment:** The revenue procedure has complete details regarding the areas in which a letter ruling will *not* ordinarily be issued. As a result, it serves to amplify and modify **Rev. Proc. 2022-3**. Appendices to the revenue procedure also include a sample "corporate governing provision statement" and a sample "shareholder statement."

> **Comment:** The revenue procedure, which includes a transition rule for pending letter ruling requests, is generally effective October 11, 2022. Also, **Rev. Proc. 2013-30** and portions of **Rev. Proc. 2022-1** are *amplified*. **(Misc.; S Corporations)**

☞**S Corporations Required to List Shareholder Loans on K-1**

The IRS will now be provided information on shareholder loans made to their S corporations. It has revised [the **2020 Schedule K-1**], **Part II, Box H** that is issued to each S firm shareholder which will report of the amount of any debt owed by the firm to that shareholder (i.e., "direct shareholder loans") at *both* the beginning and end of the year. Corporate debt owed to third parties for which the shareholder is a co-borrower or guarantor is *not* to be included. **(Code §1367; Shareholder Loans)**

> **Comment:** And, on **Schedule E, page 2**, you will continue to provide an information regarding the repayments made on "direct shareholder loans" to that particular shareholder.

Code §162 - Self-Employed Health Insurance Deduction:

☞**Shareholder's Payment of S Corp Bills Treated as Capital Contributions (*Vorreyer*, TC Memo. 2022-97 (9-21-2022))**

S corp shareholders were *not* permitted to deduct a payment that they made on behalf of an S corporation. The two taxpayers in question owned all the stock in an S corporation and decided to pay the company's utility bill and property taxes while seeking to deduct the amounts on their personal tax returns. The Tax Court agreed with the IRS that the payments should have instead been treated as capital contributions from the owners to the firm and deducted by the company. **(Code §162; Capital Contributions)**

> **Comment:** The corporation never did, in fact, claim these deductions which would have reduced the K-1 amount otherwise reported on page two of the shareholders' Schedule Es. This same result would also hold true if a partner chose to personally pay the otherwise deductible expenses of the partnership on their Form 1040.

☞**"Self-Employed" Health Insurance Deduction for Employee Family Members of > 2% Shareholders (CCA 201912001)**

The IRS has clarified that an individual who is a 2% shareholder of an S corporation as a result of the "attribution rules" under **Code §318** is entitled to the deduction under **Code §162(l)** (i.e., "self-employed health insurance deduction") for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of **Code §162(l)**.

> **Comment:** Was this clarification actually needed? Typically (i.e., based on **Rev. Rul. 91-26**), the shareholder/employee of an S corporation has "family coverage" whereby the *entire* premium for the family unit is included in their W-2 wages (but, *not* subject to any employment taxes). Then, with these wages included on the owner's **Form 1040**, a corresponding "self-employed health insurance deduction" is subtracted. Where this guidance might apply is where an adult family member of the S corporation is treated as a "2% shareholder" due to the attribution rules and otherwise has their health insurance paid for (or, premium costs reimbursed) by the S corporation (and, is *not* covered by any "subsidized health plan" (e.g., cafeteria plan or HRA).

Background: **Code §1372(a)** provides that, for purposes of applying the provisions of the Code relating to employee fringe benefits, an S corporation is treated as a partnership, and any 2% shareholder of the S corporation is treated as a partner of such partnership. For purposes of **Code §1372**, the term "2% shareholder" is *any* person who owns (or, is considered as owning within the meaning of **Code §318**) on *any* day during the tax year of the S corporation > 2% of the outstanding stock of such corporation or stock possessing > 2% of the total combined voting power of all stock of such corporation. (**Code §1372(b)**) **Code §318(a)(1)** provides that an individual is considered as owning the stock owned, directly or indirectly, by or for his spouse, children, grandchildren, and parents.

An S corporation is entitled to deduct the cost of accident and health insurance premiums paid or furnished by an S corporation on behalf of its 2% shareholders under **Code §162(a)** if the requirements of that section are satisfied. The 2% shareholder is required to include the amount of the accident and health insurance premiums in gross income under **Code §61(a)**. (**Notice 2008-1**)

Code §106 provides an exclusion from the gross income of an employee for employer-provided coverage under an accident and health plan. However, a 2% shareholder of an S corporation is *not* an employee for purposes of **Code §106**. (**Reg. §1.106-1; Code §1372(a)**)

Code §162(l)(1)(A) allows an individual who is an employee within the meaning of **Code §401(c)(1)** (i.e., a self-employed individual) to take a deduction in computing adjusted gross income for amounts paid during the tax year for insurance that constitutes medical care (i.e., under **Code §213**) for the taxpayer, his or her spouse, and dependents. However, the deduction is *not* allowed to the extent that the amount of the deduction exceeds the earned income derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established. (**Code §162(l)(2)(A)**) Also, the deduction is *not* allowed for amounts during a month in which the taxpayer is eligible to participate in any "subsidized health plan" maintained by an employer of the taxpayer or of the spouse of the taxpayer. (**Code §162(l)(2)(B)**)

A 2% shareholder-employee in an S corporation, who otherwise meets the requirements of **Code §162(l)**, is eligible for the deduction under **Code §162(l)** if the plan providing medical care coverage for the 2% shareholder-employee is established by the S corporation. (**Rev. Rul. 91-26**) A plan providing medical care coverage for the 2% shareholder-employee in an S corporation is treated as being "established" by the S corporation if:

1. The S corporation makes the premium payments for the accident and health insurance policy covering the 2% shareholder-employee (and, his or her spouse or dependents, if applicable) in the current tax year; or

2. The 2% shareholder makes the premium payments and furnishes proof of premium payment to the S corporation and then the S corporation reimburses the 2% shareholder-employee for the premium payments in the current tax year.

In order for the 2% shareholder-employee to deduct the amount of the accident and health insurance premiums, the S corporation must report the accident and health insurance premiums paid or reimbursed as wages on the 2% shareholder-employee's **Form W-2** in that *same* year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his individual tax return.

Facts: An individual owns 100% of an S corporation, which also employs the individual's family member. The family member is considered to be a 2% shareholder pursuant to the attribution of ownership rules under **Code §318**. The S corporation provides a group health plan for all employees, and the amounts paid by the S corporation under such group health plan are included in the family member's gross income.

IRS Ruling: Pursuant to the rules described above, an individual who is a 2% shareholder of an S corporation pursuant to the attribution of ownership rules under **Code §318** is entitled to the deduction under **Code §162(l)** for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of **Code §162(l)**. **(Code §162; S/E Health Insurance Deduction)**

Comment: Taxpayers who qualify under **Code §162(l)** can convert what might otherwise be a nondeductible expense (i.e., due to either the 7.5 % (or,10%) AGI floor for medical expenses in **Code §213(a)** or the fact that the taxpayer takes the standard deduction) into an "above the line" deductible item.

Code §469 - Passive Losses:

☞S Corp Shareholder's Attempt in Creating PIG Thwarted (*Rogerson*, TC Memo. 2022-49 (5/12/2022))

An S corporation shareholder attempted to split his company into two pieces while attempting to treat one side of the business as now being a generator of passive income (i.e., a PIG) to order to offset his suspended passive losses. From 2005 through 2013, the S corporation was engaged in two functions of the aerospace business with the shareholder materially participating in the S corp and, therefore, treating his involvement in the *entire* company as nonpassive. He then reorganized the business in 2014 by splitting his firm into two S corps by function (i.e., a **Code §355** "divisive reorg split-up"). Thereafter, he treated the losses from one of the S corporations as nonpassive (i.e., by continuing to materially participate in its day-to-day activities), while treating income from the other new S corp as passive in order to offset a passive loss carryforward related to his pre-2014 returns. The Tax Court agreed with the Service that he was still materially participating in each of the S corporations. As a result, neither could be a passive income generator (i.e., PIG). **(Code §469; PIGs)**

Code §1361 - S Corporation Defined:

☞S Corporation Status Retroactively Restored (PLR 202240015)

A company intended to be an S corporation from inception but failed to timely file **Form 2553 (Election by a Small Business Corporation)**. In addition, the company inadvertently filed **Form 1120 (U.S. Corporation Income Tax Return)** rather than **Form 1120-S (U.S. Income Tax Return for an S Corporation)** for its initial taxable year. Upon discovery of the error, the company sought relief under **Rev. Proc. 2013-30** to make a late S corporation election effective from the date of its formation. The IRS granted relief effective on the first date that the company was eligible for relief under **Rev. Proc. 2013-30**, but *not* back to the date of its original formation. In response to the company's subsequent letter ruling request, the IRS granted relief under **Code §1362(b)(5)** that enabled the company to treat its S election as valid from the date of formation. **(Code §1362; S Corp Elections)**

☞Careful Planning Needed for LLCs Elect S Corp Status

Although the self-employment tax savings can be powerful tax incentive when considering the conversion of an LLC taxed as a partnership to an S corporation, careful consideration should be given to those situations where guaranteed debt has been used as additional at-risk basis for taking partnership K-1 losses. The key factor is that this additional basis will immediately be lost since, under the S corporation basis rules, guaranteed debt is *not* counted (at least not until actual payments have to be made by the guarantor). Instead, only "direct shareholder loans" can be used to create additional basis beyond any stock basis (which is derived from original, as well as additional, capital contributions, along with net income to-date).

Comment: Other reasons for an LLC to make an S election might be to avoid the imposition of either the .9% or the 3.8% Medicare surtaxes (i.e., by instead making distributions of S corp profits), or simply because these partners would rather be able to take W-2 payroll v. having to receive guaranteed payments (i.e., and thus avoid, perhaps, having to make estimated tax payments throughout the year while also only having to pay the *employee's* share of payroll taxes instead of self-employment tax).

Comment: A critical planning step where guaranteed debt has been used as additional at-risk basis is to do a "novation" whereby the guarantor becomes the *primary* obligor instead of merely remaining a *secondary* obligor (who the lender looks to only when the entity has failed to make sufficient payments on the outstanding principal balance). However, many lenders do not understand this concept of "novation" even though it leaves them in the *same* position of security with regard to the debt (i.e., they have *both* the entity as well as the owners to go after for full repayment of the debt).

Another possible tax trap can be the used of "qualified nonrecourse real property indebtedness" as additional basis in those instances where the LLC holds real estate which is subject to a mortgage. Once again, the tax law contains a loophole (which was negotiated many years ago by the real estate tax shelter lobbyists) that despite no one being personally liable for the repayment of the mortgage, it is nevertheless counted as additional "at-risk basis" (as shown on **Form 6198**) for taking K-1 losses.

The bottom line is that if either if these exceptions have been used to create additional at-risk basis for taking losses, **Code §465(e)** will apply and result in"at-risk recapture." This, in turn, means that these new S corp shareholders will have immediate income recognition to the extent that they no longer have this basis for taking the earlier partnership losses that had previously flowed through to them on their respective K-1s.

Comment: The character of the income needing to be picked up in the owner's income is dependent upon the character of the loss that had previously been taken.

On a separate note, another key consideration on making the switch from LLC partnership status to that of an S corporation is "negative capital accounts." For instance, a partner who has guaranteed a debt can use this additional "soft basis" for taking a distribution that is in excess of the "hard basis" (i.e., that basis derived from capital contributions along with their share of any K-1 net income to-date) that they otherwise have in their partnership interest. In fact, *all* liabilities, even if they are *not* "at-risk" (e.g., nonrecourse debt) count for basis when determining whether a partner has sufficient basis with regard to the possible taxation of a distribution. In other words, there is no need to fill out **Form 6198** in order to determine "at-risk basis" when a distribution is made and whether or not it is taxable to the partner receiving it.

Again, when the S election becomes effective for a former LLC taxed as a partnership, the rules for capital accounts do *not* permit an S corp shareholder to have a "negative" balance. As a result, any shareholder who as a former partner had a deficit in their capital account would now have to pick up that excess as income in the first year of the S corporation's existence.

One final note concerns LLCs where there is plenty of income to cover distributions but with only some partners taking distributions while other partners do not. For instance, consider a profitable accounting firm equally owned by two partners, Steve and John. Over the course of several years, Steve has drained his share of the firm's profits to the extent of his share of K-1 income. Meanwhile, John has only extracted his share of the firm's profits to the extent needed to cover his estimated income tax liability. If this situation is *not* rectified by the time that the S election takes effect (i.e., by John taking a corresponding amount of distributions out of the LLC to even out the situation with his partner Steve), then the general rule that all S corp distributions be pro rata will come into play.

Comment: It is one thing to allow a disproportionate distribution to "make up" for prior mistakes in this area (or, where state or local income taxes have to be deposited on behalf of nonresident shareholders), but to cause an S corp to make significantly larger disproportionate distribution so as to make up for sizable unequal distributions from prior years as a partnership would be very hard to defend.

Comment: Another completely separate issue should also be considered when choosing to convert an LLC taxed as a partnership to an S corporation. Namely, the various types of ownership units a partnership entity might have outstanding. Differences in voting rights are permitted should a switch be made to S corp status. But, any other distinctions among the partners' respective interests would have to be resolved before the effective date of the S election since only one class of common stock is permitted. And, as far as what would be the initial basis of their S corp stock for tax purposes, it would most likely be whatever the final basis in their partnership interest had been, adjusted for the possible scenarios mentioned above. **(Misc.; Capital Accounts)**

☞Special Distribution Rights Granted in Divorce Did Not Create Second Class of Stock (PLR 201834007)

An S corporation will *not* be considered to have a second class of stock in violation of **Code §1361(b)(1)(D)** solely as a result of the provisions in a trust agreement. In addition, the IRS ruled that the consideration provided by one spouse-shareholder for her lifetime distribution rights in connection with a divorce from the other spouse-shareholder will *not* prevent the trust from qualifying as an "electing small business trust" (ESBT) under **Code §1361(e)(1)(C)**. **(Code §1361; S Corporations)**

Comment: Numerous cases/rulings continue to show that the IRS will not invoke the violation of the "one-class-of-stock-rules" even where preferential rights to distributions are provided for, although any such arrangement should be discontinued. The most important thing is not to have *in writing* preferential treatment where non-pro rata distributions are going to be made upon liquidation of the corporation.

☞IRS Guidance Consolidates and Extends Late S Corporation Election Relief (Rev. Proc. 2013-30)

The IRS has now provided the "exclusive simplified methods" to be used by taxpayers seeking relief for late S corporation elections; electing small business trust (ESBT) elections under **Code §1361(e)**; qualified Subchapter S trust (QSST) elections under **Code §1361(d)**; qualified Subchapter S subsidiary (QSub) elections under **Code §1361(b)(3)**; and late corporate classification elections under **Reg. §301.7701-3(c)(1)(v)(C)** which "the taxpayer intended to take effect on the same date that the taxpayer intended that an S corporation election for the entity should take effect."

Comment: This revenue procedure is still valid and is meant to consolidate relief previously provided in prior announcements, as well as actually extending that relief in certain circumstances.

Background: A corporation may make an election to be treated as an S corporation (1) at any time during the preceding tax year, or (2) at any time during the current tax year and on or before the 15th day of the third month of the tax year by filing a completed **Form 2553 (Election by a Small Business Corporation)**. (**Code §1362(b)(1), Reg. §1.1362-6(a)(2)**) Under **Code §1362(b)(3)**, if an S corporation election is made for a tax year *after* the 15th day of the third month of that tax year and *on or before* the 15th day of the third month of the following tax year, then the S corporation election is treated as made for the *following* tax year.

Under **Code §1361(b)(1)(B)**, the permitted shareholders of an S corporation are limited to domestic individuals, estates, certain trusts, and certain exempt organizations. **Code §1361(d)(1)(A)** provides that a QSST is a permitted S corporation shareholder if the beneficiary of the QSST makes an election by signing and filing an election statement with the applicable Service Center. **Reg. §1.1361-1(j)(6)(iii)** provides that the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S corporation stock is transferred to the trust.

Code §1361(c)(2)(A)(v) provides that an ESBT is a permitted S corporation shareholder if the trustee of the trust makes an election by signing and filing an election statement with the applicable Service Center. The election must be filed within the *same* time requirements as prescribed for filing a QSST election. (**Reg. §1.1361-1(m)(2)(iii)**)

Under **Code §1361**, an S corporation may elect to treat certain wholly-owned subsidiaries as QSubs electing to do so on **Form 8869** **(Qualified Subchapter S Subsidiary Election)**. The election may be filed at *any* time during the tax year. **Reg. §1.1361-3(a)(4)** provides that the effective date of the election is the date specified on the form (provided the date specified is *not* earlier than two months and 15 days *before* the date of the filing and the date specified is *not* more than 12 months *after* the date of the filing) or, on the date the election form is actually filed if no date is specified. If, instead, an election form specifies an effective date *more than two months and 15 days prior* to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. On the other hand, if an election form specifies an effective date *more than 12 months after* the date on which the election is filed, it will be effective 12 months after the date it is filed.

Reg. §301.7701-3(c)(1)(i) provides that, except as specified in the regs, an eligible entity may elect to be classified other than as provided in **Reg. §301.7701-3(b)** (i.e., normally as a partnership or SMLLC, unless it elects to be taxed instead as a corporation) by filing **Form 8832** **(Entity Classification Election)** with the applicable Service Center. **Reg. §301.7701-3(c)(1)(iii)** provides that the entity classification election will be effective on the date specified by the entity on the Form 8832 or on the date that the form is actually filed if no date is specified on the election form. But, the effective date specified on Form 8832 cannot be *more than 75 days prior* to the date on which the election is filed and cannot be more than *12 months after* the date on which the election is filed. If an election specifies an effective date *more than 75 days prior* to the date on which the election is filed, the election will be effective 75 days prior to the date it was filed. If an election specifies an effective date *more than 12 months* after the date on which the election is filed, the election will be effective 12 months after the date the election was filed.

IRS Guidance: Rev. Proc. 2013-30 provides a "simplified method" for taxpayers to request relief for late S corporation, ESBT, QSST, QSub, and corporate classification elections intended to be effective on the same date as the S corporation election for the entity. To qualify for relief, all late elections under Subchapter S must meet the general requirements in **Rev. Proc. 2013-30, §4**. Additional requirements apply for relief where one or more taxpayers request relief for multiple late elections with respect to a single S corporation. The guidance also includes "a flowchart designed to help taxpayers in applying **Rev. Proc. 2013-30**."

In addition, specific requirements in **Rev. Proc. 2013-30, §5**, through **Rev. Proc. 2013-30, §7**, apply to certain taxpayers seeking relief. **Rev. Proc. 2013-30, §5**, provides a "simplified method" for taxpayers to request relief for late S corporation elections (which may or may *not* include a "deemed entity classification election" (i.e., where an eligible entity that timely elects to be an S corporation is treated as having made an election to instead be classified as an [regular C corp] association)). **Rev. Proc. 2013-30,**

§6, provides a "simplified method" for taxpayers to request relief for late ESBT and QSST elections. **Rev. Proc. 2013-30, §7**, provides a "simplified method" for taxpayers to request relief for late QSub elections.

> **Comment:** This "simplified method" for requesting relief is in lieu of the letter ruling process formerly used for a late Election under Subchapter S. Furthermore, no user fees apply. But, a taxpayer that does *not* meet requirements specifically listed under **Rev. Proc. 2013-30**, or is otherwise denied relief under its procedures, may still seek relief by requesting a private letter ruling.

The taxpayer requesting relief (i.e., the "Requesting Entity"), which could be either the corporation or eligible entity seeking to be treated as an S corporation, the trustee seeking to treat a trust as an ESBT, a trust beneficiary seeking to treat a trust as a QSST, or a parent S corporation seeking to treat a subsidiary as a QSub, must generally request relief under **Rev. Proc. 2013-30** *within three years and 75 days after* the date the election is intended to be effective. (**Rev. Proc. 2013-30, §4.02(2)**) However, this time limit of "three years and 75 days" is *not* applicable to a corporation that fails to qualify as an S corporation solely because Form 2553 was *not* timely filed and where the corporation and its shareholders "consistently reported their income as if it was an S corporation; and neither the corporation nor its shareholders was notified by the IRS of the problem *within 6 months* of the date on which the Form 1120S for the first year was timely filed." (**Rev. Proc. 2013-30, §5.04**)

> **Comment:** This particular point is *not* entirely clear, but what the IRS is trying to say is that late election relief is still available, even though it might be requested beyond the time limit of "three years and 75 days" if the supposed S corp and its shareholders have been consistently filing on Form 1120S (i.e., as if it were, in fact, a valid S corp) and have otherwise *not* heard from the IRS (at least within the 6 months that the first Form 1120S was filed for the company) that this was in error (i.e., because a valid Form 2553 election was never actually filed). So, even if this request was beyond this time limit of "three years and 75 days," the problem could still be rectified and the IRS could *not* come in and declare that the entity has really be a C corp all along and Form 1120 (as a non-flowthrough entity) should have instead been filed (at least for the open tax years at issue).

Nevertheless, if the failure to qualify as an S corporation, ESBT, QSST, or QSub was solely because a valid election on Form 2553 under Subchapter S was *not* timely filed by the due date applicable to the election, the requesting taxpayer must also have a "reasonable cause" for this failure and must have "acted diligently to correct the mistake upon its discovery." (**Rev. Proc. 2013-30, §4.02(3) & (4)**))

> **Comment:** The IRS seems to be saying that once it's discovered that, for instance, Form 2553 was never filed, or an ineligible shareholder owned stock in the corporation, you cannot simply ignore the situation. Besides having a "reasonable cause" for this oversight (e.g., the tax accountant/lawyer never filed the election even though the taxpayer had relied on them to do so), they must also "act diligently" to fix the mistake.

Electing Process: A taxpayer request relief under **Rev. Proc. 2013-30** by properly completing the proper election forms, attaching the required supporting documents, and filing it with the appropriate IRS Service Center by (a) attaching the form to the S corporation's current year Form 1120S (as long as the current year Form 1120S is filed within 3 years and 75 days after the effective date, without considering extensions); (b) attaching the Form to one of the S corporation's late filed prior year Forms 1120S; or (c) filing the Form independent of Form 1120S. (**Rev. Proc. 2013-30, §4.03**)

For purposes of **Rev. Proc. 2013-30**, the proper election form to be used is Form 2553 for S corporation elections (including a deemed entity classification election under **Reg. §301.7701-3(c)(1)(v)(C)**); separate statements made by electing ESBTs under **Reg. §1.1361-1(m)(2)**; Form 2553 and separate statements made by electing QSSTs under **Reg. §1.1361-1(j)(6)**; and Form 8869 for QSub Elections. The election form must indicate at the top that it is filed "pursuant to **Rev. Proc. 2013-30**." Supporting statements including a **"Reasonable Cause/Inadvertence Statement"** indicating compliance with **Rev. Proc. 2013-30, §4.03(3)** must be signed under penalty of perjury. (**Rev. Proc. 2013-30, §4.03**)

Comment: Take note of the fact that **Form 8832** is *not* technically required when you want to take an LLC and treat it as an S corp for federal income tax purposes (i.e., instead of its default status as a partnership). Simply filing a valid Form 2553 would clearly indicate that you wanted to be treated as a corporation, let alone an S corporation.

Comment: The bottom line is that, on receipt of a completed request for relief, the IRS will determine whether the requirements for granting additional time to file the election under Subchapter S have been satisfied (such as having a "reasonable cause"). And, if these requirements have been met, the Service will then notify the requesting taxpayer of its determination. (**Rev. Proc. 2013-30, §4.05**)

Effective Date: Except as provided below, **Rev. Proc. 2013-30** is effective Sept. 3, 2013. In addition, **Rev. Proc. 2013-30** applies to requests pending with the IRS Service Center under **Rev. Proc. 97-48**, **Rev. Proc. 2003-43**, **Rev. Proc. 2004-48** and **Rev. Proc. 2007-62**, on Sept. 3, 2013, as well as to requests received thereafter. It also applies to *all* private ruling requests pending in the IRS National Office on that date, and to requests for relief received afterwards.

Code §1367 - S Corporation Stock Basis:

☞Form 7203 - Stock Basis Calculation for S Corp Shareholders

Comment: S corp shareholders are required to include basis information with their personal tax returns. This requirement applies to shareholders who report a loss, dispose of their stock, or receive a distribution or loan repayment from the company. Shareholders must check a box on **Line 28** of **Schedule E** and attach this new **Form 7203** basis computation.

Comment: Shareholder basis in S corporations has become a big IRS enforcement priority since owners are permitted to deduct losses only up to their stock basis and direct personal loans that they made to the company. The Service "knows that compliance in this area is deficient" and is conducting audits which will be at the shareholder level. Agents are checking to see whether shareholders are properly tracking their basis.

A. Introduction

1. According to the IRS, S corporation shareholders use **Form 7203** "to figure the potential limitations of their share of the S corporation's losses, deductions, credits, and other items that can be deducted on their individual returns."

2. **Form 7203** and its separate instructions were developed to replace the "3-part Worksheet for Figuring a Shareholder's Stock and Debt Basis" and its related instructions formerly found in the Shareholder's Instructions for Schedule K-1 (Form 1120-S) (i.e., for pre-2021 tax years).

B. Who Must File Form 7203

1. Form 7203 is filed by S corporation shareholders who:

a. Are claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations);

b. Received a non-dividend distribution from an S corporation;

c. Disposed of stock in an S corporation (whether or not gain is recognized); or

d. Received a loan repayment from an S corporation.

Comment: So, **Form 7203** is *not* just for stock basis, but also to be used to determine possible gain recognition where the S corporation makes a repayment on DSLs ("direct shareholder loans") that might have a "reduced basis."

Example: "Repayment of Reduced Basis Shareholder Loan"

An S corp shareholder makes a $100,000 loan to the company which has a current year loss allocable to this owner equal to $150,000. The shareholder's stock basis is $100,000 as well. As a result, all of their stock basis would be absorbed by this K-1 loss, while $50,000 (of the overall DSL basis of $100,000) would be used to claim the remainder of this $150,000 loss.

The following year the S corporation breaks even and there are no other increases (e.g., capital contributions) to the zero basis that the shareholder continues to have in their stock. Nevertheless, without obtaining any tax advice, the S corporation decides to repay the $100,000 balance outstanding on the DSL out of some working capital reserves.

Since it has a "reduced basis" of just $50,000, 50% of this $100,000 repayment would be taxable (as ordinary income whereas an excess distribution on stock would be LTCG).

Comment: If this S corp shareholder was that desperate in their need for funds, arguably, the S corp should have made a "loan" of this $100,000 (preferably, evidenced by a written document with a stated interest rate) to the shareholder (thus, avoiding the gain due to the repayment stated above). Then, when basis had been completely restored to this DSL, repayment could have occurred without any tax consequences.

Comment: Keep in mind, that basis restoration (e.g., allocable K-1 profit is passed out to an S corp shareholder) serves to restore "debt basis" first, before going to any "stock basis."

C. Limitations on Losses, Deductions, and Credits

1. The potential limitations and the order in which you must apply them for claiming a K-1 loss on Page 2 of Schedule E are as follows:

a. The basis limitations under **Code §1367**;

b. The at-risk limitations under **Code §465** (i.e., as shown on **Form 6198**);

c. The passive activity loss limitations under **Code §469** (i.e., as shown on **Form 8582**); and

d. The "excess business loss limitations" under **Code §461(l)** (i.e., as shown on **Form 461**).

D. Basis Calculation Under Code Sec. 1367

1. Basis is *increased* by (a) all income (including tax-exempt income such as forgiven PPP loan amounts) reported on **Schedule K-1 (Form 1120-S)**, and (b) the excess of the deduction for depletion (other than oil and gas depletion) over the basis of the property subject to depletion.

2. Basis is *decreased* (but not below zero) by (a) the FMV of any property distributions (including cash) made by the corporation reported on **Schedule K-1 (Form 1120-S)**, box 16, code D, minus (b) the amount of such distributions in excess of the current basis in the distributee's stock.

3. Basis is *decreased* (but not below zero) by (a) nondeductible expenses (e.g., 100% of any "entertainment expenses"), and (b) the depletion deduction for any oil and gas property held by the corporation, but only to the extent your share of the property's adjusted basis exceeds that deduction.

4. Basis is *decreased* (but not below zero) by all other losses and deductions (i.e., separately stated and non-separately stated) reported on **Schedule K-1 (Form 1120-S)**.

E. Election to Switch Ordering Rules for Reducing Stock Basis

1. S corp shareholders may elect to switch the "ordering rules" stated above so as to decrease their basis under (4) *prior to* decreasing your basis under (3). But, if this election is made, any amount described under (3) that exceeds the basis of your stock and debt owed to you by the corporation is treated as an amount described under (3) for the *following* tax year. By way of comparison, there is no such election available for partners.

2. To make the election, a statement must be attached to the shareholder's timely-filed original or amended return that states that they agree to the "carryover rule" of **Reg. §1.1367-1(g)** and the name of the S corporation to which the rule applies. Once made, the election applies to the year for which it is made and all future tax years for that S corporation, unless the IRS agrees to revoke this election.

F. Pro Rata Application of Various Types of Losses and Deductions on Schedule K-1

1. The basis of each share of stock is increased or decreased (but not below zero) based on its *pro rata share* of the above adjustments. And, if the total decreases in basis attributable to a share exceed that share's basis, the excess reduces (but not below zero) the remaining bases of all other shares of stock "in proportion to the remaining basis of each of those shares."

2. **Example #1: "K-1 with T/B Loss and Capital Loss"**

Assume that a shareholder has $10,000 basis in their S corporation stock (but, no "direct shareholder loans"). They receive a K-1 with a Box 1 T/B ordinary loss of $10,000 and a Box 8a LTCL of $10,000. These two respective types of losses would be applied against the shareholder's available stock basis of $10,000 using a pro rata approach. As a result, the $10,000 stock basis would be completely absorbed with $5,000 of each type of loss being carried over to future tax years.

3. **Example #2: "K-1 with T/B Loss and Nondeductible Entertainment Expenses"**
Assume that a shareholder has $10,000 basis in their S corporation stock (but, no "direct shareholder loans"). They receive a K-1 with a Box 1 T/B ordinary loss of $10,000 and a allocable share of the S corporation's nondeductible entertainment expenses of $10,000. Under the "ordering rules" mentioned above, the nondeductible entertainment expenses would completely absorb the shareholder's available basis of $10,000, leaving the entire $10,000 T/B loss to be carried over to future tax years.

Comment: The S corp shareholder (but, *not* a partner) could elect to use their $10,000 stock basis to first absorb the T/B loss. But, that would mean that the entire $10,000 of entertainment expenses would have to be carried over. However, this might make sense if their effective marginal tax rate was much higher in the year of the loss v. what they expect to have in future tax years.

G. Basis Increased by Direct Shareholder Loans to S Corporation

1. When guarantees of loans are so common today, it is critical to understand that any S corporation shareholder/guarantors would *not* receive an increase to their basis (i.e., either for taking K-1 losses or deductions, or for offsetting any distributions made during the tax year to them).

Comment: This is a key distinction when compared to partnership tax law. Under **Code §752(a)** a partner's basis in their partnership interest is increased by their allocable share of partnership debt, including any debt that the partner has guaranteed. So, if a great of borrowing and outside financing is anticipated, for example with a start-up business, it might make sense to consider using a partnership entity v. an S corporation (i.e., where up-front losses just end up being carried over).

H. DSL Basis Absorbed After Any Stock Basis

1. **Example #3: "T/B Loss with S Corp Distributions in Same Tax Year"**

An S corp shareholder has $10,000 basis in their stock, while also have an outstanding "direct shareholder loan" to the company with a basis of $10,000. Assume that the S corporation has a $10,000 T/B loss while also making a $10,000 distribution to this shareholder during the current tax year.

The $10,000 distribution can only go against the shareholder's stock basis which would bring it down to zero as of the end of the tax year. Meanwhile, the $10,000 T/B loss would have no stock basis to be offset against, but the DSL basis would then be use to allow the claiming of the loss.

Comment: Had this S corp shareholder only had a $10,000 basis in their stock and no outstanding basis in a DSL, then the $10,000 distribution would absorb the stock basis first with the $10,000 T/B loss having to be carried over to future tax years.

Comment: Same facts as above, but the S corp shareholder has zero basis in their stock as of the end of the tax year (e.g., assume that all available basis was absorbed by distributions made during the year). If there was once again a $10,000 T/B loss and $10,000 of nondeductible entertainment expenses, none of the latter expenses would have to be carried over to future tax years. Again, there is no similar rule for partnerships (i.e., both types of losses/deductions would have to be carried over).

I. Restoration of Both Stock Basis and DSL Basis

1. Always remember that neither basis can go below zero, but that "direct shareholder loans" (DSLs) can have a "reduced basis."

Comment: Since stock basis cannot go below zero (i.e., and, same rule on partner's basis in their interest), that is why cash (or, FMV of property distributions) in excess of current basis has to result in gain recognition so as to maintain the zero basis rule for S corp stock.

2. Again, when distributions are made to an S corp shareholder, that are taken into account first and can only be offset against any *stock* basis (i.e., DSL basis is *not* even considered in determining whether a distribution might be in excess of stock basis and therefore taxable).

3. On the other hand, with a K-1 reports various losses (e.g., T/B or rental) and deductions (e.g., Sec. 179), these items go against stock basis first and then, if available, against any DSL basis.

4. **Example #4: "Restoration of DSL Basis"**

Assume that an S corp shareholder has $10,000 stock basis and a $10,000 DSL basis. The S corp passes out on this shareholder's K-1 their share of a Box 1 T/B loss of $15,000. Given that there were no distributions made to this shareholder during the tax year and no other increases to the stock basis such as a capital contribution made by them to the S corp, $10,000 of the overall $15,000 loss would completely absorb their stock basis of $10,000 first. Then, the remaining $5,000 of the $15,000 T/B loss would serve to reduce the $10,000 DSL basis that they have (i.e., resulting in a "reduced basis DSL" of $5,000).

In the next tax year, the S corporation has a $10,000 T/B profit allocable to this shareholder. Assuming no other increases to this shareholder's stock or debt basis, the first $5,000 of the profit would "restore" the DSL basis to $10,000. The remaining $5,000 of T/B profit would serve to increase the shareholder's stock basis from zero to $5,000.

J. Review of Line Items on Form 2703

1. Looking at the respective line items on **Form 7203** should reinforce that principles covered above.

Comment: With the increased use of both Sec. 179 immediate expensing and 100% bonus depreciation, these write-offs, by themselves, can result in over T/B loss. And, even though this K-1 loss might be suspended due to the lack of basis (or, any of the other "restrictions" mentioned above), the bases of the assets involved still get reduced in full in the meantime.

☞**Revised Form 7203 S Corp Basis for Returns**

[Form 7203](), **S Corporation Shareholder Stock and Debt Basis Limitations (Rev. Dec. 2022)**, replaces a three-part worksheet for figuring a shareholder's stock and debt basis that used to be found in the **Shareholder's Instructions for Schedule K-1 (Form 1120-S)**. The IRS first introduced **Form 7203** in 2021 and appears to be changing it only slightly for 2022 tax year filing purposes.

Comment: **Part II** on **Page 2, Form 1040, Schedule E** continues to require the filing of **Form 7203** "If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation." If that is the case, then "you must check the box in **column (e)** on **line 28** and attach the required basis computation" (i.e., on **Form 7203**).

Comment: For tax years *before* 2021, the instructions for **Schedule K-1 (Form 1120-S)** contained a three-part worksheet that shareholders could use to track their stock bases year by year. As a worksheet in the instructions, however, it was *not* something that shareholders needed to file with their personal tax returns.

Comment: The IRS recommends that shareholders complete (and hold onto) **Form 7203** even in years in which they are *not* required to file it, simply to keep track of both their stock and debt bases.

Changes to Revised Form 7203: The draft **Form 7203** for tax year 2022 makes only two changes to the 2021 form as follows:

- **New Item D:** Shareholders will need to check a box (or, boxes) to show how they acquired the stock in the S corporation. The draft instructions say that the shareholder should check "Other" if they acquired the stock in some other way other than by purchasing it, inheriting it, receiving it as a gift, or obtaining it as an original shareholder.

- **New Item E:** This new item asks shareholders whether they have an election in effect for the tax year to reduce the shareholder's basis for the share of S corporation losses and deductions *before* reducing basis for *nondeductible* items (e.g., 50% of meals and 100% of entertainment expenses). In other words, the election *reverses* steps (3) and (4) in the process of reducing basis on the **Form 7203**.

Comment: The shareholder may want to consider making the election to avoid deferring their deduction for losses if they do *not* have sufficient basis remaining *after* reducing it for *nondeductible* expenses. This is because if this election is made, any *nondeductible* expenses would then have to be carried over to the subsequent tax year.

Comment: Remember that this election is solely for S corp shareholders and is *not* available for partners or LLC members (i.e., who are always required to reduce basis in their partnership interest by *nondeductible* items first). **([Code §1367](); Form 7203)**

☞**Basis Wasted from Prior Tax Year Not Available to Take Current K-1 Losses (*Barnes*, 111 AFTR 2d ¶ 2013-611 (CA DC 04/05/2013))**

The Court of Appeals for the District of Columbia, *affirming* the Tax Court's earlier decision, agreed that an S corp's shareholders should *not* be permitted deduct passthrough losses in a situation where they did *not* have sufficient basis in their stock. The key factor in this instance was the taxpayers' failure to take into account suspended losses from previous tax years and how these losses would have absorbed any basis they thought that might have otherwise had (i.e., before they even got to the current tax year and whether they could take these recent K-1 losses).

Comment: With all of the flowthrough entities that we prepare tax returns for, this is an incredibly important case. The bottom line is that if the client misunderstands the underlying tax law (or, more likely, we as tax preparers fail to interpret it correctly on their behalf), the client ends up suffering the consequences (or, decides to file a malpractice claim). For instance, a miscalculation of basis for a partner or S corp shareholder might mean that a K-1 loss is suspended where it should have been currently deducted. Or, the preparer does *not* understand the passive loss rules and decides that a loss must be currently suspended on **Form 8582**. Then, later on, after the statute of limitations for an amended return has passed, they learn that these prior losses could have been taken. But, then, it's too late. Yet, the taxpayer argues that this "wasted basis" should nevertheless still be available for taking more recent losses. Or, in the alternative, the preparers signs a return that is going to take these suspended losses on a prospective basis.

Comment: The bottom line is that even though the client never got a tax benefit from these losses, the statute for amending has now passed and they are gone forever. Furthermore, the tax basis of the taxpayer's interest in their partnership or S corp stock must still be correspondingly reduced.

Example: A preparer for the personal return of an LLC owner in a real estate partnership does *not* understand that "qualified real property indebtedness" can still be used under **Code §752(a)** as additional basis to take losses, even though this owner might never be personally liable for its payment (in a case where the LLC ultimately becomes incapable of repaying it). Yet, they fail to take current K-1 losses.

Example: Likewise, the preparer does *not* realize that *nonrecourse* debt (even if it's *not* "qualified real property indebtedness") still can serve as basis for distribution purposes, even if it's *not* "at-risk basis" for taking current K-1 losses. As a result, they treat a distribution as taxable when it should instead go against basis. Or, a current distribution is *not* made due to the failure to recognize that basis is otherwise available.

Example: A very common example is a real estate LLC that rents part of the building to the taxpayer's business (i.e., a "self-rental" situation), but they also have a number of other unrelated third-party lessees. The preparer erroneously treats *all* of the LLC's net rental income as nonpassive (i.e., under the recharacterization rules), instead of just the portion derived from the taxpayer's lease to his business (i.e., in which he materially participates). So, passive losses get suspended where they otherwise could have been deducted currently (i.e., given this available source of passive rental income from other third parties). Then, the discovery is made after the statute has run for amending the return. Yet, the preparer is considering still taking these losses on a prospective basis. Or, they insist that they should still have basis available in their LLC interest to at least take more recent losses.

Comment: Here, the D.C. Circuit held that both the IRS and the Tax Court were correct in finding that **Code§1367(a)(2)** requires an S corporation shareholder to reduce their basis by any losses that he is otherwise required to take into account under **Code §1366(a)(1)**. Thus, basis is reduced even if the shareholder does *not* actually claim the passthrough losses on his return. The "plain language of **Code §1366** and **Code §1367** supported the Tax Court's and IRS's interpretation of the Code." Accordingly, the taxpayer's current passthrough losses were limited because their basis was deemed to have already been reduced for prior year's losses that they had never deducted or received a tax benefit from. **(Code §1367; K-1 Basis)**

☞**Judgments Against S Corp for Loan Default Failed to Increase Shareholder-Guarantor's Basis (*Phillips v. Commr.*, 121 AFTR 2d 2018-756 (11th Cir., 5/17/2018))**

The 11th Circuit, *affirming* the Tax Court, has determined that an S corporation shareholder should *not* be permitted to increase their stock basis on account of the fact that the corporation had judgments entered against it, for which they were jointly liable, with respect to loans that they had guaranteed. The Court found that the mere fact of the judgments without any accompanying payment was insufficient to support a basis increase.

Background: Deductions and losses of an S corporation are passed through to shareholders and (except as otherwise limited by the Code) claimed on the shareholders' returns. However, a shareholder may deduct his pro rata share of these passed-through items only to the extent of the sum of the his adjusted basis in the S corporation stock, which is determined by taking into account the increases in basis for his share of the S corporation income during the year and the decreases in basis for nondividend distributions for the year (**Code §1366(d)(1)(A)**), plus his adjusted basis in any indebtedness of the S corporation owed directly to him. (**Code §1366(d)(1)(B), Reg. §1.1366-2**)

Under regs that generally apply to transactions *on or after* July 23, 2014, an S corporation shareholder who merely acts as a guarantor or in a similar capacity (e.g., surety or accommodation party) has *not* created basis of indebtedness unless the shareholder actually makes a payment, and then only to the extent of such payment. (**Reg. §1.1366-2(a)(2)(ii)**) Even for transactions *before* July 23, 2014, the courts generally held that merely guaranteeing an S corporation's debt was *not* enough to generate a basis under **Code §1366(d)(1)(B)**. To increase his basis in an S corporation, a shareholder had to make an "actual economic outlay."

In ***Selfe v. U.S.*, 57 AFTR 2d 86-464 (11th Cir., 1985)**, the 11th Circuit agreed that an economic outlay was required before a stockholder may increase her basis. Nevertheless, the Court noted that this test did *not* require that a shareholder "must, in all cases, absolve a corporation's debt before they may recognize an increased basis as a guarantor." Rather, it concluded that a basis increase may be justified "where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation."

In ***Sleiman v. Commr.*, 84 AFTR 2d 99-5987 (11th Cir., 9/16/1999),** S shareholders got no basis for personal guarantees of company debt where the 11th Circuit distinguished ***Selfe*** and held that a guaranty without payment did *not* create additional basis. In that case, the shareholder-guarantors had *not* previously been obligors on any S corporation loan and they pledged no collateral in support of their guaranties, which were requested just as a matter of the lender's policy. Rather, the collateral was supplied by the S corporation, which was successful and well established. **(Code §1366; Stock Basis)**

Comment: If you Google the following terms "S corporation novation guarantee debt," you can examine a possible strategy whereby, if you convert the S corp guarantor from a "secondary obligor" into a "primary obligor," additional basis can be created, especially where there is inadequate stock basis to take an anticipated K-1 loss for the tax year and additional "debt basis" is needed to make up this gap.

Code §1374 - Built-in Gains Tax:

☞**C Corp Electing S Status Allowed Built-In Loss for Bonuses Pegged Against Cash Basis Receivables (PLR 200925005)**

A cash basis personal service corporation (PSC) that elected S status was permitted to offset the potential built-in gain from the eventual collection of cash basis receivables with a built-in loss. Essentially, this took the form of a bonus for services rendered by its professional shareholder (as well as its nonshareholder employees) that was recorded on the books of the former C corporation during its last days of existence, but which was paid within 2½ months after becoming an S corp.

> **Comment:** Key to the favorable result in this ruling was the fact that the taxpayer would pay to its shareholder/employees within the first *two and one-half months* of the recognition period, all salary and wage expenses that were related to the production of accounts receivable that were outstanding as of the effective date of the S election.

> **Comment:** As to the payments made to any *nonshareholder* employees, these could be made at any point during the 10-year built-in gains period (i.e., 5 years today, but the *same* time frame as that for any other accounts payable or other unpaid payroll expenses).

Background: **Code §1374(d)(4)** provides that any loss recognized on a disposition of an asset during the recognition period is recognized built-in loss to the extent the S corporation establishes that it held the asset on the first day of the recognition period and such loss does *not* exceed the excess of (i) the adjusted basis of such asset as of the beginning of such first taxable year, over (ii) the fair market value of such asset as of such time. **Code §1374(d)(5)(B)** provides that any item of deduction properly taken into account during the recognition period but attributable to periods before the first day of the recognition period is recognized built-in loss for the taxable year for which it is allowable as a deduction. **Code §1374(d)(5)(C)** provides that an S corporation's net unrealized built-in gain is properly adjusted for items of income and deduction that would be recognized built-in gain or loss if taken into account during the recognition period. **Reg. §1.1374-4(b)(2)** provides, in relevant part, that "any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer." **Reg. §1.1374-4(c)** limits the treatment under **Reg. §1.1374-4(b)(2)** of items of deduction properly taken into account during the recognition period as recognized built-in loss. The limitation of **Reg. §1.1374-4(c)** applies to items of deduction constituting payments to related parties and any amount properly deducted during the recognition period under **Code §404(a)(5)** (i.e., relating to payments for deferred compensation). **Reg. §1.1374-4(c)(1)** (relating to regular compensation such as bonuses paid out of receivables) provides that any payment to a related party properly deducted in the recognition period under **Code §267(a)(2)** will be deductible as recognized built-in loss only if: (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is paid: (A) within the first two and one-half months of the recognition period; or (B) to a related party owning less than five percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid. Meanwhile, **Reg. §1.1374-4(c)(2)** (relating to deferred compensation payments) provides that any amount properly deducted in the recognition period under **Code §404(a)(5)** will be deductible as recognized built-in loss to the extent: (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is *not* paid to a related party to which **Code §267(a)(2)** applies. **(Code §1374; BIG Tax)**

> **Comment:** This is one of the prime considerations when a PSC decides to elect S status. Namely, if a cash basis accounts receivable is subject to the built-in gains tax, the rate could effectively go as high as 57.5% (i.e., 35% x $100 of BIG + (35% x ($100 - 35 BIG tax)). Whereas, if S election

had never been made, then the PSC would have simply paid out these receivables as collected with the only tax being that paid at the shareholder/employee's marginal tax rate (i.e., at most, 35%). And, the IRS has won at least two cases where the planning outlined above was not properly consummated and the cash basis receivables subsequently collected by the S corp were subject to the built-in gains tax. **Tax impact now with flat C corp rate of 21% would be 50.23% ((21% x $100 of BIG) + (37% x ($100 - 21 BIG tax))**.

Code §1375 - Excess Passive Investment Income:

☞**Since "Significant Services" Provided, Sec. 1375 Penalty Not Applicable (PLR 201812003)**

C corporations with any retained earnings (i.e., even $1) that elect S corp status must be careful not to run afoul of this penalty. Too much "passive income" (which has nothing to do with **Code §469**) can result in a 35% (now, 21% which is the current rate for C corporations) penalty tax. The penalty applies if over 25% of the S corp's gross receipts is received from passive sources such as interest, dividends, and any rents and royalties that are *not* derived from an active trade or business. More importantly, S status can be lost if the 25% limit is exceeded in *three consecutive years*. But, rental income is *not* considered to be "passive" for purposes of the penalty under **Code §1375** if the S corporation provides "significant services" or incurs substantial costs in the process of receiving these rental amounts.

The IRS has once again confirmed this in a recent private letter ruling where an S corporation owned and leased farm property to tenants to plant and cultivate crops. It also shared in the farm related expenses, furnished materials for building maintenance and repair, and was responsible for the crop plan. As a result, such management services and expenditures made the character of the rents the S corporation got from its tenants nonpassive. **(Code §1375; Penalty Taxes)**

Code §3402 - Withholding Taxes:

☞**S Corp Owner Not Liable for Failure to Deposit and Pay Penalties on "Non-Wage Advances" (*Ryan, Inc.*, TC Summary Opinion 2010-18 (2/23/2010))**

The Tax Court has concluded that an S corporation, solely owned and operated by one individual, was *not* liable for penalties for a failure to deposit and pay payroll taxes where its CPA advised that it could simply have an "annual payroll" while simultaneously transferring advances to the owner's personal account throughout the year that would *not* be treated as wages. In rendering this advice, the CPA had incorrectly advised that these "advances" would *not* constitute wages at the time of transfer, so long as "the owner had an obligation to repay the advances." At the end of the year, the owner would then satisfied his repayment obligation when the corporation credited the advances made with the compensation due to the owner for his services, resulting in a net payment of zero. **(Code§3402; Withholding Taxes)**

Comment: In reaching its conclusion, the Tax Court turned aside the IRS's argument that it was unreasonable for the taxpayer to rely on the CPA's advice "because he did *not* base his opinion on any specific Code provision (i.e., he simply consulted an IRS publication), and that the advice was wrong." The Court noted that while the taxpayer "may have been ill- advised, that was *not* the standard for a reasonable cause determination."

Comment: Even though the taxpayer here was let off the hook (due to his reliance on his CPA) for only issuing one paycheck for the entire tax year, while simultaneously making distributions throughout the year, we should advise clients in similar situations to take out at least some of the

S corp's profits throughout the year as a "reasonable salary" (and, *not* to take all of the monies as "salary advances" or simply distributions with only one paycheck dedicated solely to withholding taxes at yearend).

Code §6699 - Failure-to-File Penalty:

☞**Late Filing Penalty Still Applied to S Corp Where Shareholders Only Obtained Personal Filing Extensions (*ATL & Sons Holdings, Inc.*, 152 TC No. 8 (3/19/2019))**

An S corporation was liable for the **Code §6699** penalty for failure to timely file its return, even though its shareholders obtained an extension to file their personal tax return (and timely did so). The Court further determined that since the penalty "was automatically calculated through electronic means no supervisory approval was needed to impose the penalty." The Court reasoned that an S corporation is an entity separate from its shareholders. And, as such, an S corporation does *not* normally incur a liability for Federal income tax. (**Code §1363(a)**) Instead, its shareholders are taxed on their respective shares of the S corporation's income. (**Code §1366(a)(1)**) However, an S corporation is required to file an annual information return on its own **Form 1120S**, and on that return it reports its own income, deductions, and other matters. (**Code §6037(a)**, **Reg §1.6037-1(a)**) To extend the time to file the S corporation return, a separate form - **Form 7004** **(An Application for an Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns)** - is required under **Reg §1.6081-3(a)(1)**. In this instance, the S corporation did *not* file **Form 7004** nor any other document requesting an extension of the deadline for filing its 2012 **Form 1120S** (**Code §6699**; **IRS Penalties)**

> **Comment:** There was no mention in this case whether the taxpayers applied for a "first-time abatement" from the IRS to relieve them of this late-filing penalty (since the relief accorded by **Rev. Proc. 84-35** is only available for the late filing of partnership tax returns).

S CORPORATIONS - CONSULTING ISSUES:

Code §1361 - Electing S Corp Status:

☞**Careful Planning Needed for LLCs Elect S Corp Status**

> **Note: Under the new tax proposals certain "older" S corporations might be able to effectively "check the box" and convert over to being an LLC without any immediate tax ramifications.**

Although the self-employment tax savings can be powerful tax incentive when considering the conversion of an LLC taxed as a partnership to an S corporation, careful consideration should be given to those situations where guaranteed debt has been used as additional at-risk basis for taking partnership K-1 losses. The key factor is that this additional basis will immediately be lost since, under the S corporation basis rules, guaranteed debt is *not* counted (at least not until actual payments have to be made by the guarantor). Instead, only "direct shareholder loans" can be used to create additional basis beyond any stock basis (which is derived from original, as well as additional, capital contributions, along with net income to-date).

> **Comment:** Other reasons for an LLC to make an S election might be to avoid the imposition of either the .9% or the 3.8% Medicare surtaxes (i.e., by instead making distributions of S corp profits), or simply because these partners would rather be able to take W-2 payroll v. having to

receive guaranteed payments (i.e., and thus avoid, perhaps, having to make estimated tax payments throughout the year while also only having to pay the *employee's* share of payroll taxes instead of self-employment tax).

Note: The new tax proposals would impose the 3.8% Medicare surtax now on certain S corp distributions, even if made to "active" shareholders.

Comment: A critical planning step where guaranteed debt has been used as additional at-risk basis is to do a "novation" whereby the guarantor becomes the *primary* obligor instead of merely remaining a *secondary* obligor (who the lender looks to only when the entity has failed to make sufficient payments on the outstanding principal balance). However, many lenders do not understand this concept of "novation" even though it leaves them in the *same* position of security with regard to the debt (i.e., they have *both* the entity as well as the owners to go after for full repayment of the debt).

Another possible tax trap can be the used of "qualified nonrecourse real property indebtedness" as additional basis in those instances where the LLC holds real estate which is subject to a mortgage. Once again, the tax law contains a loophole (which was negotiated many years ago by the real estate tax shelter lobbyists) that despite no one being personally liable for the repayment of the mortgage, it is nevertheless counted as additional "at-risk basis" (as shown on **Form 6198**) for taking K-1 losses.

The bottom line is that if either if these exceptions have been used to create additional at-risk basis for taking losses, **Code §465(e)** will apply and result in"at-risk recapture." This, in turn, means that these new S corp shareholders will have immediate income recognition to the extent that they no longer have this basis for taking the earlier partnership losses that had previously flowed through to them on their respective K-1s.

Comment: The character of the income needing to be picked up in the owner's income is dependent upon the character of the loss that had previously been taken.

On a separate note, another key consideration on making the switch from LLC partnership status to that of an S corporation is "negative capital accounts." For instance, a partner who has guaranteed a debt can use this additional "soft basis" for taking a distribution that is in excess of the "hard basis" (i.e., that basis derived from capital contributions along with their share of any K-1 net income to-date) that they otherwise have in their partnership interest. In fact, *all* liabilities, even if they are *not* "at-risk" (e.g., nonrecourse debt) count for basis when determining whether a partner has sufficient basis with regard to the possible taxation of a distribution. In other words, there is no need to fill out **Form 6198** in order to determine "at-risk basis" when a distribution is made and whether or not it is taxable to the partner receiving it.

Again, when the S election becomes effective for a former LLC taxed as a partnership, the rules for capital accounts do *not* permit an S corp shareholder to have a "negative" balance. As a result, any shareholder who as a former partner had a deficit in their capital account would now have to pick up that excess as income in the first year of the S corporation's existence.

One final note concerns LLCs where there is plenty of income to cover distributions but with only some partners taking distributions while other partners do not. For instance, consider a profitable accounting firm equally owned by two partners, Steve and John. Over the course of several years, Steve has drained his share of the firm's profits to the extent of his share of K-1 income. Meanwhile, John has only extracted his share of the firm's profits to the extent needed to cover his estimated income tax liability. If this situation is *not* rectified by the time that the S election takes effect (i.e., by John taking a corresponding amount of distributions out of the LLC to even out the situation with his partner Steve), then the general rule that all S corp distributions be pro rata will come into play.

> **Comment:** It is one thing to allow a disproportionate distribution to "make up" for prior mistakes in this area (or, where state or local income taxes have to be deposited on behalf of nonresident shareholders), but to cause an S corp to make significantly larger disproportionate distribution so as to make up for sizable unequal distributions from prior years as a partnership would be very hard to defend.

> **Comment:** Another completely separate issue should also be considered when choosing to convert an LLC taxed as a partnership to an S corporation. Namely, the various types of ownership units a partnership entity might have outstanding. Differences in voting rights are permitted should a switch be made to S corp status. But, any other distinctions among the partners' respective interests would have to be resolved before the effective date of the S election since only one class of common stock is permitted. And, as far as what would be the initial basis of their S corp stock for tax purposes, it would most likely be whatever the final basis in their partnership interest had been, adjusted for the possible scenarios mentioned above. **(Misc.; Capital Accounts)**

☞Making S Election to Save on 3.8% Medicare Surtax

A doctor owned 100% of a C corporation which operated a surgery center. Contemplating retirement, he was offer a million dollar plus incentive to sell the assets of his business. But, as the sole owner of a non-flowthrough entity, his material participation over the many years counting for nothing as far as demonstrating that this was a "nonpassive entity." Instead of consummating the sale in late 2022, upon the advice of his tax professional, he delay the sale until early 2023. In the meantime, he made an prospective S corporation election on **Form 2553** to be effective as on 1/1/2023. There would be "double taxation" whether he did a sale of the former C corporation assets (i.e., under **Code §336** and **Code §331**, or having the "built-in gains" tax provision under **Code §1374** otherwise apply. Nevertheless, with being an S corporation as of the date of the sale, his material participation meant that this was no longer a passive activity. Therefore, the **Code §1411** Medicare surtax (i.e., as shown on **Form 8960**) did *not* apply. **(Code §1411; Medicare Surtax)**

> **Comment:** This rather simple planning tip saved over $180,000 with regard to the recent sale of this doctor's surgery center.

Notes:

ESTATES, GIFTS & TRUSTS:

Miscellaneous:

☞**Inflation Adjusted Numbers for 2023 (Rev. Proc. 2022-38)**
Here's a summary of the federal estate and gift tax parameters for 2023:

- Annual Federal Gift Tax Exclusion: The annual federal gift tax exclusion for 2023 is $17,000 per gift recipient, up from $16,000 for 2022. The exclusion amount is the maximum that can be transferred during 2023 to a single gift recipient without any federal gift or estate tax impact because gifts up to the exclusion amount do *not* affect a taxpayer's overall unified federal estate and gift tax exemption (i.e., unified credit equivalent). (**Code §2503**)

> **Comment:** How often have significant transfers (i.e., gifts) been made by clients and they never thought to inform us? Is this something that we should have as a follow-up question when preparing their return?

- Unified Federal Gift and Estate Tax Exemption: For individuals who make gifts in 2023 or die in 2023, the unified credit equivalent is $12.92 million, up from $12.06 million for 2022 (i.e., an increase of $860,000).

> **Comment:** As a result of the "portability election," the 2023 exemption for a married couple is effectively doubled to $25.84 million (i.e., 2 x $12.92 million) which represents an increase of $1.72 million over the 2022 deal. (**Code §2010**)

> **Comment:** A married couple would now be able to collectively pass along assets in their respective estates of almost $26 million. But if the TCJA provision is *not* renewed, the former $5 million unified credit equivalent amount (*adjusted for inflation* as of the time of its reintroduction) would come back into play for transfers made after 2024. Transfers made prior to 2025, however, would still be able to count on the larger amount that was in place at the point the transfer was originally made (i.e., 2018 through 2024).

- Generation-skipping Transfer Tax (GSTT): The federal GSTT is imposed by **Code §2515**. The annual exclusion for generation-skipping gifts is the *same* as for the annual gift tax exclusion. As a result, the exclusion for 2023 is $17,000, up from $16,000 for 2022. In addition, the unified GSTT exemption for lifetime gifts and bequests is also the same as the unified credit equivalent amount. As a result, the exemption for 2023 is $12.92 million or effectively $25.84 million for a married couple, up from $12.06 million and $24.12 million, respectively, for 2022.

- Noncitizen Spouses: Noncitizen spouses are ineligible for the unlimited marital deduction privilege under **Code §2523**, which allows unlimited transfers between citizen spouses, while alive or at death, without any federal gift or estate tax liability. However, noncitizen spouses are eligible for a much larger annual federal gift tax exclusion, due to **Code §2523(i)**. For 2023, the exclusion is $175,000, up from $164,000 for 2022.

- Special Use Valuation: The special estate tax valuation of real estate is increasing for 2023 pursuant to **Code §2032A**. Up to $1,310,000 of farm or business real estate can receive a discount valuation which allows estates to value the realty at its current use instead of its fair market value. To qualify, the real estate must make up at least one-half of the estate, and property making up 25% or more of the estate must be used in a business or actively farmed by the decedent or their family for five or more years in the eight years before death.

- **Installment Payments of Estate Tax:** A larger portion of an estate tax liability will qualify for an installment payment tax break under **Code §6166**. If one or more closely-held businesses make up greater than 35% of a 2023 estate, as much as $700,000 of tax can be deferred, and IRS will charge only a 2% interest rate. **(Misc.; 2023 Tax Numbers)**

☞**Key Inflation-Adjusted Numbers for 2024 Tax Year**

Unified Estate and Gift Tax Exclusion Amount:

For gifts made and estates of decedents dying in 2024, the exclusion amount (i.e., unified credit equivalent) will be $13,610,000 ($12,920,000 for gifts made and estates of decedents dying in 2023).

> **Comment:** This amount would drop dramatically back down to just $5,000,000, plus an adjustment for inflation for the period 2018 through 2024, should the **TCJA** provisions *not* be continued which will be dictated by who controls Congress and the White House after the Nov. 2024 elections.

Generation-skipping Transfer (GST) Tax Exemption:

The exemption from GST tax will be $13,610,000 for transfers in 2024 ($12,920,000 for transfers in 2023).

Gift Tax Annual Exclusion:

For gifts made in 2024, the gift tax annual exclusion will be $18,000 ($17,000 in 2023).

> **Comment:** With "gift splitting" between spouses, this exclusion doubles to $36,000. And, of course, the unified credit can be used to avoid any gift tax should total gifts made by the taxpayer for the year exceed the annual exclusion amount. **(Misc.; 2024 Key Tax Numbers)**

> **Comment:** If a Sec. 529 educational set-aside plan is being established, then five times this annual exclusion amount (i.e., $90,000) can be initially contributed ($180,000, if two parents/grandparents are contributing a combined amount). Then, no further contributions can be made for the ensuing five-year period. But remember that up to $10,000/year can be now used for the costs of pre-kindergarten through high school, let alone the costs of post-secondary education.

☞**Reminder on Form 1041 Instructions**

The 2020 Instructions for **Schedule K-1** note the following changes:

- **Excess deductions on termination: Box 11, Code A**, is revised to now read **"Excess deductions-Section 67(e) expenses"** and a *new* **Box 11, Code B**, **"Excess deductions-Non-miscellaneous itemized deductions"** was added.

> **Comment:** This is an important distinction since 2% miscellaneous deductions were eliminated starting with the 2018 tax year. So, even if the taxpayer still itemizes their deductions on **Schedule A**, they would *not* be able to take these deductions upon termination of the estate **Form 1041**.

The instructions also contain the following reminder:

- **Qualified business income deduction:** The **Schedule K-1**, **Box 14, Code I**, related to the "qualified business income deduction" under **Code §199A**, has been changed. If applicable, a worksheet or statement containing information needed to figure the beneficiary's qualified business income deduction should be attached to the beneficiary's **Schedule K-1** (i.e., since **Box 20, "Other Information"** has only **"Code Z"** by way of explanation).

☞**Final IRS Rules Set Fee for Estate Tax Closing Letters (T.D. 9957)**

Individuals requesting letters to confirm the IRS has accepted a **Form 706** estate tax return will be required to pay a $67 fee under these new final regulations. The rules follow the Service's 2015 decision to stop issuing the letters, known as "estate tax closing letters," *automatically*. Estate executors, local probate courts, state tax departments, and others often rely on the letters, which include useful information such as the net estate tax amount, for confirmation that the IRS has completed its examination of a return. The IRS has said that this fee "will help the government recover the costs it incurs providing estate tax closing letters." **(Misc.; Estate Closing Letters)**

> **Comment:** Executors rely on the closing letters before making final distributions of bequests to heirs because the heirs could be held liable for unpaid estate taxes as transferees. The fee is effective beginning Oct. 28, at which time executors can go to the IRS **website** to submit their requests and pay the cost. In addition, the IRS is doing away with faxed submissions regarding requests for these letters.

> **Comment:** The charge is appropriate given the Service's "resource constraints and the convenience the letters afford to the individuals requesting them," the IRS said in the proposed version of the rules.

Code §67 - 2% Miscellaneous Deductions:

☞**Final Regs Released on Deductions for Estates and Non-Grantor Trusts, Including Excess Deductions on Termination (IR-2020-217)**

Final **regulations** have been issued that provide guidance for decedents' estates and non-grantor trusts clarifying that certain deductions of such estates and non-grantor trusts are *not* to be treated as "miscellaneous itemized deductions" (i.e., such as those limited to 2% of AGI which were eliminated by the TCJA for individuals, estates, and non-grantor trusts for any taxable year beginning *after* Dec. 31, 2017, and *before* Jan. 1, 2026).

Specifically, the final regulations clarify that the following deductions are allowable in calculating AGI and are *not* miscellaneous itemized deductions:

- Deductions for costs paid or incurred in connection with the administration of the estate or trust which would *not* have been incurred if the property were *not* held in such estate or non-grantor trust;

- The deduction concerning the personal exemption of an estate or non-grantor trust;

- The distribution deductions for trusts distributing current income; and

- The distribution deductions for trusts accumulating income

In addition, the final regulations provide guidance on determining the character and amount of, as well as the manner for allocating, excess deductions that beneficiaries succeeding to the property of a terminated estate or non-grantor trust may claim on their individual income tax returns (i.e., on Schedule A, if they choose to itemize their deductions). **(Code §67; Miscellaneous Deductions)**

☞**Service Clarifies Form 1041 Deductions for Estates and Trusts (IR 2020-90)**
The IRS has issued proposed regulations (REG-113295-18) that provide that certain deductions of estates and nongrantor trusts are *not* "miscellaneous itemized deductions" for federal income tax purposes. Specifically, the proposed regulations clarify the following deductions are allowable in figuring AGI and are *not* miscellaneous itemized deductions: (1) costs paid or incurred in connection with the administration of the estate or trust which would *not* have been incurred otherwise, (2) deductions concerning the personal exemption of an estate or nongrantor trust, (3) deductions for trusts distributing current income, and (4) deductions for trusts accumulating income. Finally, the guidance clarifies how to determine the character, amount, and manner for allocating excess deductions that beneficiaries succeeding to the property of a terminated estate or nongrantor trust may claim on their individual income tax returns. **(Code §67; Form 1041)**

> **Comment:** With this clarification of what will *not* be treated as "miscellaneous itemized deductions," the TCJA elimination of such write-offs will *not* impact claiming these items on Form 1041.

Code §170 - Charitable Contributions:

☞**Increasing Interest Rates Benefit Charitable Remainder Annuity Trusts**
These trusts involve a donor transferring cash or other assets to an irrevocable trust. The trust then takes the donor's tax basis in the assets with the trust paying an annuity to the donor (or, another person) for a set term, with the remainder ultimately going to charity. The donor gets an up-front charitable deduction for the present value of the remainder interest. And when interest rates are rising, the IRS valuation tables assume the charity will get an even more valuable asset in the end. Since the value of the donated asset is worth more, the current tax deduction is higher. Payments of income from the trust to the beneficiaries are generally taxable and the trust is required to file Form 5227 and reports the distributed amounts on Schedule K-1. **(Code §170; CRATs)**

> **Comment:** Abusive charitable remainder annuity trusts, however, remain one of the Service's main targets with the inclusion of such trusts of the IRS "Dirty Dozen" list. They normally involve situations where a donor transfers appreciated property to a trust and improperly claims that the trust can step up its basis in those assets to their fair market value. The trust then sells the property but maintains that it need *not* recognize any gain. The trust then uses the proceeds to purchase an annuity, and the beneficiaries try to report as income only a small amount of the annuity payments.

☞**Distribution Clause Rendered CRAT Null and Void (*Estate of Block*, TC Memo. 2023-30 (3/13/2023))**
The tax use of charitable remainder annuity trusts become more attractive in an increasing interest environment. CRATs provide for an up-front charitable deduction (i.e., based on a present value calculation) for cash or other assets being donated to a qualified charity, with this irrevocable trust paying an annuity to the donor (or, another designated third-party) for a set term. The remainder interest ultimately goes to the charity at the end of this term.

There are, however, some strict rules that must be filed in order to get the desired tax result. In a recent case, a decedent set up a CRAT which would be funded upon his death, with her sister being the initial income beneficiary. The terms of the trust instrument stated that the annuity payments to the sister "in an amount equal to the *greater* of $50,000 or the trust's net income." This clause violated the CRAT rules that require payments to noncharitable beneficiaries to be *either* a fixed amount or an amount equal to a fixed percentage of the value of the trust's assets. Even when the trustees attempted to enact a "qualified reformation" of the trust's terms to satisfy the CRAT rules, it was to no avail. It resulted in the Tax Court agreeing that the deduction for the charitable remainder interest should be denied. **(Code §170; CRATs)**

Code §469 - Passive Loss Rules:

☞**Trusts/Estates Not Eligible for PAL Real Professional Exception (CCA 201244017)**

Under **Code §469(c)(7)(B)**, "real estate professionals" may treat otherwise passive rental real estate activities as nonpassive if (1) more than 50% of personal services during the tax year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer spends more than 750 hours of service during the tax year in real property trades or businesses in which they materially participate. Nevertheless, the IRS has confirmed that a trust is *not* able to meet these qualifying tests because they are intended to apply only to *individuals*. In other words, only individuals are capable of "performing personal services" and the statute states that the personal services must actually be performed by the taxpayer. **(Code §469; PALs)**

☞**Only Trustee Fiduciary-Capacity Activities Count for PAL Material Participation Test (TAM 201317010)**

The only court opinion addressing how a trust establishes "material participation" for purposes of the **Code §469** passive activity loss rules is ***Mattie K. Carter Trust v. U.S.*, 91 AFTR 2d 2003-1946 (N.D. TX, 2003)**, where a Texas District Court looked at the activities of the trust's fiduciaries, employees, and agents in determining whether the trust's participation was "regular, continuous, and substantial (i.e., so as to constitute "material participation" under **Code §469**)" Now, this new IRS technical advice memo rejects this approach in favor of one that "focuses solely on the activities of the trustee(s)." Specifically, it stated that: "Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity." In other words, a trust "should be treated no differently." Based on this approach, the trusts "did *not* materially participate in the relevant activities of the S corporation during the tax years at issue within the meaning of **Code §469**." **(Code §469; PALs)**

☞**Trust Eligible for Real Estate Professional Exception to PAL Rules (*Aragona Trust*, 142 TC No. 142 TC No. 9 (3/27/2014))**

A trust that owned real estate properties and engaged in other real estate activities qualified for the **Code §469(c)(7)** exception for "real estate professionals." As a result, the trust was *not* subject to the passive activity loss limitations. A key factor was that the Court found that services performed on behalf of a trust by the trustees may be considered personal services performed by the trust. **(Code §469; REP Exception)**

> **Comment:** Remember, if it was merely the beneficiaries of the trust (i.e., instead of the trustees) performing these services, it would *not* have satisfied the "material participation" test under the **Code §469** passive loss rules (Cf. ***Maggie Carter Trust***).

Code §1014 - Basis of Property Acquired from Decedent:

☞**No Basis Step-up for Certain Inherited Grantor Trust Assets (Rev. Rul. 2023-02)**

Rev. Rul. 2023-02 confirms that the basis adjustment under **Code §1014** generally does *not* apply to the assets of an irrevocable "intentionally defective" grantor trust that are *not* included in the deceased grantor's gross estate for Federal estate tax purposes. The gift tax rules do *not* apply to "step-up" the basis of assets gifted to an *irrevocable* grantor trust by completed gift in cases in which such assets are *not* ever going to be included in the gross estate of the owner of the trust for Federal estate tax purposes. In such cases, even though the grantor trust's owner is liable for Federal income tax on the trust's income while alive, the assets of the grantor trust are *not* considered "as acquired or passed from a decedent by bequest, devise, inheritance, or otherwise" within the meaning of **Code §1014(b)**. Therefore **Code §1014(a)** does not apply. **(Code §1014; Grantor Trusts)**

> **Comment:** The bottom line is that assets inherited under such circumstances take the *carryover* basis that the decedent had as of the time of their death.

> **Comment:** These so-called "intentionally defective grantor trusts" are set up by making a completed gift but the grantor is still considered to be the owner of the asset(s) transferred during their lifetime. Nevertheless, the grantor does *not* have to include the asset(s) in his estate upon death. It has been a long-standing controversy as to whether these excluded assets are entitled to a step-up to FMV as of the date of the decedent's death. Now, this IRS ruling makes clear that the tax basis of the asset(s) is equal instead to the decedent's carryover basis immediately before their death.

Code §2010 - Unified Credit Equivalent:

☞**Final Regs Offer Assurance of Higher Unified Credit Equivalent for Pre-2026 Transfers (TD 9884)**

For estates of decedents dying and gifts made *after* 2017 and *before* 2026, the **Tax Cuts and Jobs Act** *doubles* the basic exclusion amount from $5 million to $10 million, as adjusted for inflation ($11.4 million and $11.58 million for 2019 and 2020, respectively). Under these recently-released final regulations, taxpayers who take advantage of the increased exclusion will *not* be adversely affected when (and, if) it reverts back to the pre-TCJA amount in 2026. In that situation, if the portion of the allowable credit amount as of the decedent's date of death is less than the sum of the credit amounts that were allowable in computing gift tax payable, the estate tax credit is based on the greater of the two amounts. **(Code §2031; Unified Credit Equivalent)**

> **Comment:** The final regs adopt, with certain revisions, regulations first proposed in November 2018.

☞**IRS Proposes Exception to Special Rule Regarding Estate Tax Unified Credit Equivalent Amount (REG-118913-21)**

The IRS has proposed an exception to the special rule protecting gifts made *before* 2026 from the declining basic exclusion amount (i.e., unified credit equivalent amount). **Prop. Reg. §20.2010-1(c)(3)** would provide an exception to the special rule for transfers that are includible, or are treated as includible, in a grantor's gross estate (i.e., testamentary gifts that take effect as of the date of the grantor's death).

Increased Basic Exclusion Amount: In 2017, **Code §2010(c)(3)** was amended to increase the basic exclusion amount (BEA) (i.e., unified credit equivalent amount) to $10 million adjusted for inflation (i.e., increased BEA). The increased BEA applies to decedents dying and gifts made *after* December 31, 2017, and *before* January 1, 2026. On January 1, 2026, however, the BEA will revert back to $5 million adjusted for inflation. As a result of this reversion to a lower amount, the IRS in 2019 issued final regs that included a "special rule" to ensure that a donor's estate would *not* be taxed on completed gifts that, due to the increased BEA, would *not* have been subject to any gift tax when originally made.

Nevertheless, this special rule in the final regs failed to distinguish between two types of transactions that the Code treats differently:

1. Completed gifts that are treated as "adjusted taxable gifts" but are *not* includible in the grantor's gross estate for estate tax purposes ("not-includible gifts"); and

2. Completed gifts that are treated as testamentary transfers (i.e., ones which take place upon the death of the grantor such as those pursuant to a revocable living trust) includible in the grantor's gross estate for estate tax purposes (i.e., "includible gifts").

Proposed §20.2010 Regs: Recognizing the statutory distinction between "includible" and "not-includible gifts," **Prop. Reg. §20.2010-1(c)(3)** would provide an exception to the special rule for transfers that are "includible" (or, are treated as includible), in a grantor's gross estate. This exception would also apply to certain transfers that effectively allow the donor to retain enjoyment of the gifted property for life. However, the special rule would continue to apply to transfers includible in the gross estate when the taxable amount of the gift is 5% or less than the total amount of the transfer, as valued on the date of the transfer.

Example: The proposed regs contain the following example to illustrate the new exception:

Assume that when the unified credit equivalent amount was $11.4 million (i.e., $10 million adjusted for inflation), a donor gifted an enforceable $9 million promissory note to their child. This transfer constituted a completed gift of $9 million.

On the donor's death, the assets that are to be used to satisfy the note are part of the donor's gross estate, with the result that the note is treated as "includible" in the gross estate for purposes of **Code §2001(b)**. As a result, the $9 million gift is excluded from "adjusted taxable gifts" in computing the tentative estate tax under **Code §2001(b)(1)**.

Nevertheless, if the donor dies *on or after* January 1, 2026, the unified credit equivalent amount to be applied in computing the donor's estate tax is the credit based upon the BEA allowable *as of the donor's date of death* (i.e., $6.8 million).

Applicability Date: These proposed rules would apply, after being published as final, to the estates of decedents dying *on or after* April 27, 2022. While the special rule will *not* be needed until the BEA decreases by statute (i.e., after 12/31/2025), if a BEA decrease is enacted on or after April 27, 2022, but before final regs are issued, the proposed exception to the special rule would apply to the estates of decedents dying *on or after* April 27, 2022. **(Code §2010; Unified Credit Equivalent)**

Code §2031 - Definition of Gross Estate:

☞**Appeals Court Confirms Gifted Checks Must Be Cashed Before Death to Avoid Estate Taxes (*Estate of DeMuth*, No. 22-3032, (3rd Cir., 7/12/2023))**

This case involved an estate and the timing rules for gifting checks to relatives immediately before death.

The decedent regularly made gifts to his family up to the annual exclusion amount, including in his year of death. Five days before he died, his son, as his representative, wrote 10 checks from his dad's investment account as gifts and mailed them or personally delivered them to the relatives. Three recipients deposited their checks *before* the decedent died, but most deposited them later. The 3rd Circuit Court of Appeals *affirmed* this 2022 Tax Court ruling that the checks deposited *after* the decedent's death were *not* "completed gifts" made during his lifetime and must instead be included in the decedent's gross estate for federal estate tax purposes. **(Code §2031; Completed Gifts)**

☞**Gifting Assets Out of Decedent's Estate (*Allison*, Doc. No. 29 (D.C., Calif., 2/24/2022))**
Close attention should be paid to the timing rules when gifting a check to a family member. Namely, the recipient must actually *deposit* a personal check for it to count as a gift for estate and gift tax purposes (i.e., so as to get that amount out of the decedent's potential estate). The rules differ, however, when gifting a cashier's check. In that instance, the recipient must *physically receive* the cashier's check before it counts as a gift. In this recent case, a recipient initially refused a cashier's check made out by a decedent shortly before death. Four months later, the estate canceled the original check and paid the amount again, which was then accepted and received. The cashier's check is included in the decedent's estate for estate tax purposes. **(Code §2031; Taxable Estate)**

☞**Valuing GRAT Interest Includible in Decedent's Estate (*Badgley*, No.18-16053 (9th Cir., 4/28/2020))**
The tax benefit associated with the use of a grantor-retained annuity trust (GRAT) can result in significant gift-tax savings. Individuals who set up a GRAT receive an annuity for a set term with any balance remaining after that time going to beneficiaries named by the grantor as receiving the remainder interest. The actuarial value of the remainder interest in the GRAT is treated a taxable gift, but low interest rates serve to diminish the value of the remainder interest, which in turn, helps to minimize the gift tax otherwise due. A key point to remember, however, is that if the grantor dies during the GRAT's term (even if it is only one day before the term would have otherwise ended), the *entire* value of the present interest is included in the final estate of the decedent. Here, the terms of this GRAT were to make annual payments to the grantor for 15 years, or until death if she died sooner, with the remainder interest going to her children. She died three months before the GRAT's term ended. The estate's executor insisted that only the net present value of the *unpaid* annuity payments should be included in her estate. But an appeals court disagreed, saying the *entire* value of the assets in the GRAT at the time of her death should be included in her estate. **(Code §2031; GRATs)**

Code §2032A - Special Use Valuation:

Special Use Valuation Interest Rates (Rev. Rul. 2021-15)
The IRS has issued the 2021 interest rates to be used by estates of decedents in computing the "special use value" of farm real property for which an election is made under Code §2032A. Under **Code §2032A(e)(7)(A)(ii)**, rates on new **Farm Credit System Bank** loans are used in computing the special use value of real property used as a farm for which an election is made under **Code §2032A**. This revenue ruling contains a list of the "average annual effective interest rates" on new loans under the **Farm Credit System**, and a list of the states within each Farm Credit System Bank Chartered Territory. The rates in the revenue ruling may be used by estates that value farmland under **Code §2032A** as of a date in 2021. **(Code §2032A; Special Use Valuation)**

Code §2033 - Property in which Decedent Had an Interest:

☞**Checks Includible in Decedent's Gross Estate (*Estate of William DeMuth*, TC Memo 2022-72 (7/12/2022))**

In 2007, the decedent executed a Power of Attorney (POA) appointing his son as his agent. From 2007 through 2014, the son gave annual gifts to his brothers and other family members. Prior to the decedent's death, 11 gift checks were written on an investment account. Also, prior to the decedent's death, one check was deposited and paid; three checks were deposited and unpaid; and seven of the 11 checks were deposited subsequent to death. The son excluded the total of the 11 checks from the estate return. The IRS issued a notice of deficiency for the value of the 10 checks that were *not* paid until after the decedent's death. The Tax Court held that gift checks written *before* death but *not* paid (i.e., actually deposited) until *after* death were includible in the decedent's gross estate. **(Code §2033; Taxable Estate)**

Code §2051 - Gross Estate:

☞**Insurance Proceeds Properly Valued in Estate Tax Assessment (*Connelly*, 131 AFTR 2d 2023-711 (8th Cir., 6/2/2023))**

Two brothers were the sole owners of a corporation. They decided to enter into a stock-purchase agreement with their corporation whereby if one of them were to die, the company would redeem his shares for $3 million using the life insurance proceeds. One brother passed away in 2013 and the other in 2014. The estate of the first brother claimed on the Form 706 that his shares were worth $3 million. But the IRS, upon auditing the return, found that the fair market value of the corporation was undervalued. The 8th Circuit agreed with the IRS decision to also include the life insurance proceeds in determining fair market value for estate tax purposes since the $3 million amount was described as "part of a larger, post-death agreement between the first brother's estate and the son of the second brother that had passed away, thereby resolving several estate-administration matters." **(Code §2031; Gross Estate)**

> **Comment:** Valuing a decedent's shares in a closely-held corporation can be can be a difficult prospect. In this instance, life insurance proceeds served to increase the estate tax value of the shares of the first brother to die in the discussion above. The stock's value of $3 million set forth in the stock purchase agreement was disregarded. Instead, when accounting for the life insurance proceeds, the estate tax valuation of the decedent's shares was closer to $5.3 million.

> **Comment:** Executors who want estate tax closing letters must request them online at www.pay.gov and pay a $67 fee. These letters verify that an estate's **Form 706** has been accepted by the Service as filed or that audit changes have been agreed to. More importantly, executors rely on the letters *before* making final distributions of bequests to heirs because the heirs could be held liable for unpaid estate taxes as transferees. But there is a more expedient alternative to the estate tax closing letters. Executors (or, their tax representatives) can view and print an "estate tax return transcript" on IRS's **Transcript Delivery System**. Transcripts that include "transaction code 421" will confirm the **Form 706** has been accepted as filed or that any audit is complete. However, there might be at least a nine-month after filing the **Form 706** before an account transcript is available.

☞**Estate Value of Closely-held Company Included Life Insurance Proceeds (*Connelly*, 128 AFTR 2d 2021-XXXX (DC Mo))**

Under **Code §2051**, a decedent's taxable gross estate includes all of the decedent's property valued as of the decedent's date of death minus otherwise allowable deductions. The taxpayer were brothers who owned a roofing and siding business. They entered into a stock purchase agreement that required the company to buy life insurance in order to purchase back the shares of the first brother to die (i.e., a buy-sell agreement). To exclude the value of a buy-sell agreement from an estate valuation, the buy-sell agreement must (1) be a bona fide business arrangement; (2) not used to transfer property to family members for less than full and adequate consideration; and (3) have terms similar to a negotiated arm's length transaction. The Court ruled that the estate had to include the value of the insurance proceeds since the buy-sell agreement failed to satisfy the exception to the "general valuation rule." **(Code §2051; Buy-Sell Agreements)**

> **Comment:** Clients considering these buy-sell arrangements should make sure that they get competent tax planning advice to avoid having the insurance proceeds includible in the shareholder's estate as was the case here.

Code §2053 - Expenses, Indebtedness & Taxes:

☞Application of Present Value Concepts and Estate Deductions (REG-130975-08)

The IRS has released proposed regulations on the proper use of "present-value principles" in determining the amount deductible by an estate for funeral expenses, administration expenses, and certain claims against the estate under **Code §2053**. In addition, the proposed regulations provide guidance on the deductibility of interest expense accruing on tax and penalties owed by an estate, and interest expense accruing on certain loan obligations incurred by an estate. The proposed regulations also amend and clarify the requirements for substantiating the value of a claim against an estate that is deductible in certain cases and provide guidance on the deductibility of amounts paid under a decedent's personal guarantee.

The IRS wants is trying to tighten the rules on deducting claims against estates. Under current law, estate tax deductions are allowed for claims over $500,000 only when they are paid, without the need to calculate the claim's present value. These claims are generally deducted on amended returns if paid after Form 706 has been filed. On the other hand, smaller claims can be deducted on the estate tax return *before* they are actually paid.

The proposed regs would use present-value principles to calculate certain claims against the estate. This would include those claims that *both* exceed $500,000 and are paid at least three years *after* the death of the decedent. The estate tax deduction based on the proposed regs would be limited for the claim to the present value of the paid amount as of the decedent's death. The present value of the payment would be computed by discounting the payment from the payment date to the decedent's date of death, using the applicable federal rate for the month in which the decedent's date of death occurs, compounded annually. **(Code §2053; Estate Deductions)**

> **Comment:** The proposed regulations would be applicable to the estates of decedents dying *on or after* the date the regulations are published as final.

Code §6018 - Estate Tax Returns:

☞IRS Simplifies Estate Tax Portability Election (Rev. Proc. 2022-32)

Rev. Proc. 2022-32 provides a "simplified method" for certain estates to obtain an extension of time under **Reg. §301.9100-3** to file a return *on or before* the *fifth* anniversary of the decedent's death to elect portability of the deceased spousal unused exclusion (DSUE) amount pursuant to **Code §2010(c)(5)(A)**. For purposes of federal estate and gift taxes, a "portability election" allows a **Deceased Spousal Unused**

Exclusion (DSUE) amount to become available for application to the surviving spouse's subsequent transfers during life or at death. This simplified method applies to estates that are *not* normally required to file an estate tax return because the value of the gross estate and adjusted taxable gifts is under the filing threshold in **Code §6018(a)** and is to be used in lieu of the letter ruling process. Furthermore, no user fee is required. **(Code §6018(a); DSUE)**

> **Comment: Rev. Proc. 2022-32** supersedes **Rev. Proc. 2017-34**.

☞**IRS Grants Extension for Portability Election (PLR 202317013)**

The IRS granted an estate a 180-day extension to make a portability election. Pursuant to **Reg. §301.9100-3** the IRS is given discretion to grant extensions of time for making elections whose due dates are "prescribed by regulation" but *not* for those due dates "expressly prescribed by statute." Due dates for the portability election are "prescribed by statute" for estates required to file estate tax returns but "prescribed by regulation" for estates *not* required to file (i.e., estates below the unified credit exemption amount). The decedent's estate represented that based on the value of the gross estate, taking into account any prior taxable gifts, that the estate was *not* required to file a **Form 706** estate tax return. As a result, the IRS had discretion to grant "**Reg. 301.9100-3** relief." **(Code §2010(c)(5)(A); Portability Election)**

> **Comment:** On July 8, 2022, the IRS released **Rev. Proc. 2022-32**, which updates and expands the "simplified method" for estates to obtain an extension of time to make a portability election under **Code §2010(c)(5)(A)**. The revenue procedure became effective the day it was released, *supersedes* **Rev. Proc. 2017-34**, and allows estates with no filing requirement under **Code §6018(a)** to obtain an extension to make a portability election up until the *fifth* anniversary of a decedent's date of death, subject to certain requirements.

> **Comment:** Another example of relief regarding tax filing deadlines which can be found under **Reg. 301.9100-2** is the *automatic* 12-month extension to file a Sec. 754 step-up election for a partnership.

Code §6166 - Extension of Time to Pay Estate Tax:

☞**Special Use Valuation Election Allowed on Late-filed Form 706 (*Estate of Parks*, D.C., Mich. (11/18/2022))**

A late-filed **Form 706** did *not* prevent an estate from electing to use the "special use valuation rule." This discount valuation approach is for "actively farmed property" where estates are permitted to value part of their farm or business realty at its current value as a business asset instead of its fair market value based on the property's "highest and best use." To qualify, the realty must make up at least one-half of the estate, and property which makes up 25% or more of the estate must be used in a business or actively farmed by the decedent or their family for five or more years in the eight years before death. The executor is required to elect this discount valuation on **Form 706**. Under temporary regs, an election is valid if made on the "first filed estate tax return," even if that return is *not* timely filed. In this instance, however, the executor made the election on an estate tax return that was filed five years late. The IRS argued the executor's election was invalid but the district court concluded that the election was timely, relying on the explicit language in the temporary regs. **(Code §2032A; Special Use Valuation)**

> **Comment:** The special estate tax valuation of real estate increases as in 2023 whereby up to $1,310,000 of farm or business real estate can receive discount valuation with the deferred taxes carrying only a 2% interest rate.

Code §6320 - Notice and Opportunity for Hearing Upon Filing of IRS Lien:

Executor Personally Liable for Unpaid Estate Tax (*Estate of Kwang Lee*, TC Memo 2021-92 (7/20/2021))

Under the **Federal Priority Statute (FPS)**, an executor is personally liable for unpaid claims of the U.S. to the extent the executor distributes assets from the estate while the executor also has knowledge or notice of the U.S.'s claim. In 2006, the IRS sent this taxpayer, who was an attorney and estate executor, a notice of deficiency for $1 million, which he disputed. In 2007, he distributed $640,000, leaving $183,000 in the estate. In May 2010, the Tax Court confirmed that the estate owed more than $500,000 in estate tax. The IRS declined an Offer in Compromise (OIC) because it included amounts collectible from the executor under the FPS. The Tax Court agreed that the taxpayer in this instance had knowledge and notice of the estate tax claim in 2007 and should be held personally liable for the estate tax claim. **(Code §6320; Tax Penalties)**

Code §6324 - Transferee Liability:

☞**Beneficiaries Still Liable for Unpaid Estate Taxes Years Later When Property Distributed (*Paulson*, No. 21-55197 (5/17/2023))**

The decedent died in 2001 with an estate worth about $200 million, most of which was placed in a inter vivos trust. His estate filed **Form 706**, paying a portion of the tax owed, while opting to remit the remainder in a series of installments. However, the estate ceased making payments in 2007 and then commenced distributing all of the property held in trust over the ensuing six years (i.e., 2007 through 2013). The IRS was forced to seek payment of the estate tax balance from the beneficiaries under the principle of "transferee liability" which invokes joint and several liability for each and every one of the heirs who received assets out of the estate, limited to the value of the property received. **(Code §6324; Transferee Liability)**

☞**10-Year Statute of Limitation Applies to Estate Tax Collection from Transferees (*Johnson*, 123 AFTR 2d 2019-1272 (10th Cir., 3/29/19))**

Upon timely filing the estate tax return, a decedent's trustees elected to defer a portion of the tax under **Code §6166(a)** (i.e., using the installment payment provisions with interest only for the first five years). Later that year, the trust distributed the remaining assets, primarily stock in a hotel, to the heirs. A decade later, the hotel went bankrupt, and the estate defaulted. As a general rules, transferees of an estate's property are personally liable if the estate tax is *not* paid when due (**Code §6324(a)(2)**). The statute of limitations for collection of estate tax is *ten* years from the first assessment, which must be made within *three* years after the return filing (**Code §§6501(a)** and **6502(a)**). But, the statute of limitations is suspended while the **Section 6166(a) Election** is in effect (**Code §6503(d)**). The District Court in Utah originally ruled that the IRS could *not* bring a transferee liability claim under **Code §6324(a)** because the liability was governed by **Code §6901(a)** as a "breach of contract" subject to the state statute of limitations, which was time-barred. The 10th Circuit *reversed and remanded* the case. Because the IRS brought the case under **Code §6324(a)(2)** within the *ten-year* statute of limitations, as extended by the **Section 6166(a) Election**, the government's claim was timely and valid. **(Code §6324; Transferee Liability)**

Code §6901 - Transferee Liability:

☞**IRS Goes After Heirs for Unpaid Estate Taxes (*Ringling*, No. 4:17-cv-04006 (2/21/2019))**

A district court confirmed that the heirs can be held liable for a proportionate share of any unpaid estate taxes based on the relative FMV of the property or cash that they received from the estate. In this instance, the decedent transferred property to his children a few months before he died. They also inherited additional property and cash upon his death. When the estate failed to paid its estate tax liability, the Service sought to recoup the taxes from the heirs who were found to be liable. **(Code §6901; Estate Tax)**

☞**Executor/Sole Heir Liable for Unpaid Estate Taxes (*Estate of Kelley*, Case No. 3:17-cv-965-BRM-DEA (D.C., N.J., 10/22/2020))**

When the decedent passed away, her will left all of her estate to her brother, who was also the executor. He proceeded to transfer all the estate's property to himself, even though he was aware that the estate had an outstanding tax liability of $688,644 plus statutory IRS additions (i.e., penalties and interest). The District Court had no problem finding that the IRS was entitled to collect the estate tax from the brother as both a beneficiary and as an executor. **(Code §6901; Tax Liens)**

Code §8938 - Statement of Specified Foreign Financial Assets:

☞**Estate Liable for Decedent's Willful Failure to File FBARs (*Estate of Danielsen*, 126 AFTR 2d 2020-5343 (DC FL 10/6/2020))**

The District Court here affirmed the imposition by the IRS of a $6.4 million judgment against an individual's estate for the decedent's failure to file Foreign Bank Account Reports (FBARs) for his two foreign bank accounts. The taxpayer, a U.S. citizen, began selling Swiss annuities in 1993. Shortly thereafter, he formed a corporation, and opened two foreign accounts, in the corporation's name. From 2006 through 2009, the taxpayer was the "beneficial owner of, and had a financial interest in," the two foreign accounts as corporation's sole owner. More importantly, the aggregate monthly balance in the foreign accounts always exceeded $10,000. However, despite previously filing FBARs for different foreign accounts, the taxpayer did *not* file FBARs for the foreign accounts owned through his corporation. Also, for each year between 2006 and 2009, the taxpayer answered "No" to the question on **Line 7(a)** of **Schedule B**, "Did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country?" The IRS assessed FBAR penalties for the years 2006 through 2009, which the taxpayer failed to pay. And, after he died, his estate also failed to pay the assessed FBAR penalties.

District Court Decision: The district court agreed that the taxpayer's estate was liable for the FBAR penalties, pointing to the fact that the taxpayer had filed FBARs for different foreign accounts in 1994 and 1995, which "was evidence that he knew he was required to file FBARs for his foreign accounts" as well as his answer of "No" on **Schedule B** each of the years in question. As a result, the court held that the taxpayer had "recklessly disregarded" his duty to report his foreign accounts and this omission was "willful." **(Code §8938; FBAR)**

Notes:

RETIREMENT PLANS & FRINGE BENEFITS:

Miscellaneous:

☞**Upcoming SECURE 2.0 Changes for Retirement Plans**

The **2022 SECURE ACT 2.0** retirement savings law has over 90 provisions which are meant to encourage more folks to save for retirement in workplace plans as well as IRAs. The intent is also to help increase retirement savings and to urge smaller employers to offer retirement plans. Some of the provisions are effective for this year. Others commence in 2024, 2025, 2026 and 2027.

Changes Taking Effect in 2023: First, here is a reminder of one change which takes effect for the 2023 tax year:

- The required minimum distribution age increases to 73 starting on January 1, 2023. The RMD age will again increase to 75 **starting on January 1, 2033**.

> **Comment:** The original proposal in the **SECURE Act 2.0** was to gradually raise the RMD age from 72 to 73, and then in a few years to 74, and finally, to age 75 starting in 2030 but this version of the proposed law did *not* it pass the Senate. Nevertheless, this change recognizes the fact that more senior citizens are working longer.

2024 Tax Year Changes: The provisions taking effect in 2024 are as follows:

- Employers will now be able to make matching contributions to an employee's 401(k) or 403(b) retirement plan (given their plan provisions offer this option) when an employee makes a student loan repayment, thus enabling the employee to pay off their student loan and save for retirement at the same time.

> **Comment:** Student loan debt, according to the Federal Reserve in 2021, impacts 45 million Americans whose combined debt for student loans is $1.75 trillion. This new provision also applies to SIMPLE IRAs with respect to "qualified student loan payments." A qualified student loan payment is broadly defined as any indebtedness incurred by the employee solely to pay qualified higher education expenses of the employee. Governmental employers are also permitted to make matching contributions in a section 457(b) plan or another plan with respect to such repayments.

- Funds remaining in Sec. 529 educational accounts can be rolled over tax-free to a Roth IRA. However, there is a $35,000 lifetime cap. Furthermore, the rollover amounts are *not* permitted to exceed the otherwise applicable annual contribution limit for Roth IRAs. Finally, the Sec. 529 account must have been open for more than 15 years.

> **Comment:** According to the **Senate Finance Report**, families and students have concerns about leftover funds being trapped in Sec. 529 accounts unless they take a non-qualified withdrawal and assume a penalty (at least on the earnings portion of the account). This has led to hesitating, delaying, or declining to fund Sec. 529 plans to levels needed to pay for the rising costs of education. **SECURE Act 2.0** is meant to eliminate this concern by providing families and students with the option to avoid the penalty, resulting in families putting more into their Sec. 529 plans. Families who sacrifice and save in Sec. 529 accounts should *not* be punished with tax and penalty years later if the beneficiary has found an alternative way to pay for their education. They should be able to retain their savings and begin their retirement account on a positive note.

> **Comment:** According to **savingforcollege.com**, money can be kept in a 529 plan *indefinitely*. 529 plans can be used for graduate school, not just undergraduate school, and can be passed on to one's children. There is also no age limit on contributions to a 529 plan. Furthermore, up to $10,000 of earnings can be used annually for K-4 through high school.

- Roth 401(k) and 403(b) account owners no longer need to take required minimum distributions. This now conforms to the rule that already is in place for Roth IRA account owners.

- Qualified retirement plan sponsors are permitted to create "emergency savings accounts" for participants, who could then make Roth contributions (i.e., on an after-tax basis) to that savings account within the plan. However, a participant's account balance is *not* permitted to exceed $2,500.

Comment: This would apply to "emergency expenses" which are "unforeseeable or immediate financial needs relating to personal or family emergency expenses." Only *one* distribution is permissible annually of up to $1,000. In addition, a taxpayer has the option to repay the distribution within 3 years. But no further emergency distributions are permissible during the "3 year repayment period" unless repayment actually occurs.

- 401(k) and 403(b) catch-up contributions by employees age 50 or older with FICA earnings over $145,000 were to get Roth (i.e., after-tax) treatment. But the IRS recently announced that this change will be delayed until the 2026 tax year.

- More penalty-free early withdrawals will be allowed. For example, domestic abuse victims under 59½ can take up to $10,000 from their IRAs or 401(k)/403(b) plans without paying the 10% early withdrawal penalty. In addition, as mentioned above, up to $1,000 can be withdrawn penalty-free from these respective accounts for emergencies.

- The employer contribution limits for SIMPLE-IRAs will increase.

Comment: This increases the *annual* deferral limit, as well as the *catch-up* contribution at age 50 by 10 percent, as compared to the limit that would otherwise apply in the first year this change is effective, in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4 percent matching contribution or a 3 percent employer contribution. Sec. 117 makes similar changes to the contribution limits for SIMPLE 401(k) plans.

Comment: The new law also permits an employer to make additional contributions to each employee of a SIMPLE IRA plan in a "uniform manner," provided that the contribution may *not* exceed the *lesser* of up to 10 percent of compensation or $5,000 (which will be indexed for inflation).

- Employers with no existing retirement plans can offer "starter 401(k) or 403(b) accounts" with default automatic enrollment (with a payin cap the same as that for IRAs).

Comment: This will now permit an employer that does *not* sponsor a retirement plan to offer a "starter 401(k) plan" (or, a "safe harbor 403(b) plan"). A starter 401(k) plan (or, a "safe harbor 403(b) plan") would generally require that *all* employees be default enrolled in the plan at a 3 to 15 percent of compensation deferral rate. The limit on annual deferrals would be the *same* as the IRA contribution limit, which for 2022 is $6,000 ($6,500 for 2023) with an additional $1,000 ($1,000 for 2023 as well) in catch-up contributions beginning at age 50.

- The $1,000 IRA catch-up contribution amount for people 50 and older will now be adjusted for inflation.

Comment: While we are discussing these upcoming retirement plan changes, it would also be wise to advise your clients to review their retirement plan beneficiaries if they have not done so recently. It is key to avoid unintended consequences by updating beneficiary designations for both 401(k) or 403(b) plans, annuities, pensions and IRAs to account for any life changes such as marriage, divorce or the death of a spouse or other listed beneficiary. Also, have them look the beneficiaries listed in their wills, taxable accounts and life insurance policies.

☞ **SECURE Act 2.0 Retirement Bill**

Background: A bipartisan retirement bill approved last year by the House of Representatives' Ways and Means Committee is now coming to the House floor for a full vote during the week beginning

March 28. The **Securing A Strong Retirement Act of 2021 (H.R. 2954)**, often referred to as **SECURE 2.0**, received *unanimous* support when approved by the Ways and Means Committee on May 5, 2021. The goal of the bill "is to increase retirement savings and simplify and clarify retirement plan rules." If approved by the full House, the bill would then move to the Senate for final approval.

> **Comment:** A separate comprehensive handout covering both **SECURE 1.0** and **SECURE 2.0** has been included with this workshop.

The key provisions of the bill include:

- **Expanding automatic enrollment in retirement plans:** The bill requires 401(k) and 403(b) plans to automatically enroll participants upon their becoming eligible (although, employees may opt out). The initial automatic enrollment amount is at least 3% but no more than 10%. And each subsequent year the amount is increased by one percentage point until reaching 10%. There is an exception for small businesses with 10 or fewer employees, new businesses (those that have been operating for less than three years), church plans, and governmental plans.

- **Indexing IRA catch-up limit:** Under current law, the limit on IRA contributions is increased by $1,000 (i.e., a "catch-up amount" which is *not* indexed) for individuals who have reached age 50. The bill would now include the indexing of these limits starting in 2023.

- **Even higher catch-up limit to apply at age 62, 63, and 64:** Under current law, employees who have reached age 50 are permitted to make catch-up contributions under a retirement plan in excess of the otherwise applicable limits. The limit on catch-up contributions for 2021 is $6,500, except in the case of SIMPLE plans, for which the limit is $3,000. This pending legislation would increase these limits to $10,000 and $5,000 (both indexed) for individuals who have reached ages 62, 63, and 64 but *not* 65.

> **Comment:** Obviously, these provisions would *not* have any impact on those taxpayers who are already age 65 or older. Just the RMD extension mentioned below would possibly come into play.

- **Increase in age for required beginning date for mandatory distributions:** Under current law, participants are generally required to begin taking distributions (i.e., RMDs) from their retirement plans at age 72. The bill increases the required minimum distribution age further to 73 starting on January 1, 2022, while also increasing this the "age threshold" further to 74 starting on January 1, 2029, and 75 starting on January 1, 2032.

- **SIMPLE and SEP Roth IRAs:** Generally, all plans that allow pre-tax employee contributions also are permitted to accept Roth contributions with one exception (i.e., SIMPLE IRAs). In other words, 401(k), 403(b), and governmental 457(b) plans are allowed to accept Roth employee contributions. The provision in the bill would now also allow SIMPLE IRAs to accept Roth contributions as well. **(Misc.; Retirement Legislation)**

☞**SECURE 2.0 Relief for Retirement Plan Disaster Distributions**

A special provision in **SECURE 2.0** allows disaster victims to receive retirement-related payouts without any imposition of the 10% early withdrawal penalty. This relief applies for "federally declared disasters" occurring *on or after* Jan. 26, 2021. The 10% penalty on pre-age-59½ payouts from IRAs and plans is waived on up to $22,000 per disaster. But the payout must be taken within 179 days of the date the disaster is declared. The payout deadline is June 27, 2023, for disasters that arose on Jan. 26, 2021, through Dec. 28, 2022.

At the option of the taxpayer, income tax otherwise due on these "qualified disaster distributions" can be paid over three years, or the individual can choose to pay the tax all at once. Amounts recontributed to the retirement account within the three-year time span are treated as nontaxable rollovers. **Form 8915-F** is used to spread the tax on the payouts. Income tax paid on a distribution that is subsequently rolled over back into the IRA or retirement plan within three years of the distribution can be recovered by filing an amended return on **Form 1040-X**.

Instead of taking a distribution, eligible disaster victims can instead choose to borrow an even larger amount from their 401(k) or 403(b) retirement plans. Up to the *lesser* of $100,000 or 100% of the account balance can be loaned out. In addition, repayment terms otherwise required under the terms of the plan can be extended by one year, but only if the plan allows for this special disaster relief.

Pre-disaster payouts to buy a home in the disaster area can be recontributed to the retirement plan, provided the funds were *not* ultimately used to buy a residence. **(Misc.; Disaster Distributions)**

> **Comment:** Another exception to the **Code §72(t)** 10% early withdrawal penalty is for "first-time home purchases." But, given that a disaster has occurred in the area that the taxpayer had intended to use these funds to buy the home, they can now instead return the distribution to the retirement plan without any imposition of income tax (or, penalty).

> **Comment:** Although disasters around the country have continue to occur, Congress would have to specifically extend the time deadlines to include these more recent occurrences happening after Dec. 28, 2022.

☞**Transition Period for Roth Catch-up Contributions (Notice 2023-62)**

The IRS has announced a two-year "administrative transition period" for the new Roth "catch-up requirement." The **SECURE 2.0 Act** requires certain catch-up contributions to an employer retirement plan to be designated as Roth (i.e., after-tax) contributions *after* 12/31/23. This new rule applies to employees who participate in an employer or governmental retirement plan and whose prior-year Social Security wages exceeded $145,000. Nevertheless, during this "transition period," an employer plan will *not* be deemed to have failed meeting any requirement of the Code solely because the plan permits an eligible participant to make *pre-tax* catch-up contributions. In addition, for tax years beginning after 12/31/23, and before 1/1/26, a plan may permit participants to make elective deferrals that exceed the cap ($22,500 for 2023) when those excess contributions satisfy the catch-up contribution requirements (even if the contributions are *not* designated as after-tax Roth contributions). Additionally, a plan that does *not* provide for designated Roth contributions will have satisfied the requirements of **Code §414(v)(7)(B)**. **(Code §414; IRA Catch-up Contributions)**

> **Comment:** Essentially, for the 2024 and 2025 tax years, individuals whose employment tax wages exceed $145,000 will still be able to choose between making either *pre-tax* or *after-tax* catch-up contributions into their employer's qualified retirement plan (i.e., 401(k), 403(b) or 457 plans).

☞**Using Educational Assistance Programs to Pay Employee's Student Loans (Tax Tip 2023-114)**

Employers that offer educational assistance programs under **Code §127** can also use those same programs to now help pay their employees' outstanding student loans. Though educational assistance programs have been available for many years (with the same $5,280 cap for the last 40 years or more), the option to instead use them to pay student loans is available only for payments made *after* March 27, 2020 and through the end of the 2025 tax year.

Traditionally, educational assistance programs have been used to pay for books, equipment, supplies, fees, tuition and other education expenses for the employee. But these programs can now also be used to pay principal and interest on an employee's "qualified education loans." Payments made directly to the lender, as well as those made to the employee, qualify. As mentioned above, tax-free benefits under an educational assistance program are limited to $5,250 per employee per year. Normally, assistance provided above that level is taxable as wages. **(Code §127; Educational Assistance)**

> **Comment:** For information on other requirements, see **IRS Pub. 15-B, Employer's Tax Guide to Fringe Benefits**. **Chapter 10** in **IRS Pub. 970, Tax Benefits for Education** provides details on what qualifies as a student loan.

> **Comment:** Before the AICPA put in place the 150-credit-hour requirement to sit for the CPA exam, it was very common for a firm to identify a newer staff's potential, for example, in the tax area. So, with a few years experience under their belts, they would go back to grad school for an MS in tax or accounting/auditing. And, the classes would mean much more as they could now relate to what was being taught on a practical level.

> **Comment:** The approach now is going to gravitate to a model where a new undergrad can intern and receive credit for their practical experience, with the accounting firm also covering some of the costs associated with that last 30 credit hours.

☞Changes to Applicability Date for Final RMD Regs and Transition Relief (Notice 2023-54)

The IRS has provided transition relief for plan administrators, payors, plan participants, IRA owners, and beneficiaries in connection with the change in the required beginning date (RBD) for Required Minimum Distributions (RMDs) amended by the **SECURE 2.0 Act of 2022**. The notice provides guidance related to "certain specified RMDs" for 2023 and announces that the final regulations that will be used related to RMDs will apply for purposes of determining RMDs for calendar years beginning no earlier than 2024. As a result of this amendment, IRA owners who will attain age 72 in 2023 will have a required beginning date of 4/1/25, rather than 4/1/24. **(Code §401(a)(9); RMDs)**

> **Comment: SECURE 2.0** amended **Code §401(a)(9)(C)** delaying the required beginning date for **Code §401(a)** plans and other eligible retirement plans distributed in **Code §402(c)(8)**, including IRAs.

> **Comment:** In proposed regs issued in March of 2022, the IRS "clarified" that if the decedent had already reached their "required beginning date" at the time of their death (i.e., and, therefore, were required to begin making their RMDs), then any non-spousal beneficiary (e.g., children inheriting the funds) had to continue extracting the RMDs (using their life expectancy) over years 1 through 9, with the account being fully depleted by the end of year 10. Under transition rules contained in this IRS notice, however, the IRS waived any penalty (which has now been reduced by the **2022 SECURE 2.0 Act** from 50% down to 25%, and possibly, 10%) if such beneficiaries failed to take RMDs for *either* the 2021 or 2022 tax years, and now also for the 2023 tax year.

☞<u>2023 Inflation-Adjusted Increases Impacting Retirement Plans</u> (Notice 2022-55)

The following are the 2023 inflation-adjusted increases with regard to retirement plans:

- Defined benefit plan maximum benefit going from $245,000 to $265,000

- Defined contribution plan maximum deposit going from $61,000 to $66,000

- 50-and-over catch-up contribution going from $6,500 to $7,500

- 401(k)/403(b)/457 plan maximum deferral going from $20,000 to $22,500

Example: "Solo 401(k) Defined Contribution Plan Deferral"
John is the sole owner and employee of his S corporation and is over 50 years of age. For 2023, he will be able to set aside $30,000 (i.e., $22,500 + $7,500 catch-up) for his 401(k) plan. Even though *employment* taxes of $4,590 (i.e., 2 x 7.65% x $30,000) will have to be paid, no current *income* taxes would be due. Subtracting this $30,000 from the $66,000 defined contribution plan maximum deferral cap, this leaves $36,000 which can still be deferred by way of employer contributions to his 401(k) plan. The employer contribution cap is 25% x John's salary. So, dividing $36,000 remaining under the overall $66,000 deferral cap would allow up 25% of $144,000 of his salary to be subject to this employer matching contribution. Of course, factoring the employer's and employee's share of employment tax, this would be at a potential cost of $22,032 in employment taxes (i.e., 15.3% x $144,000, since the FICA cap for 2023 is going up to $160,200).

Comment: The obvious question is whether it is better to pay the additional salary to John in the example above at the 15.3% cost of additional employment taxes as opposed to having some of the S corporation's profits being paid out as K-1 distributions (thus, saving the current 15.3% employment tax cost, but subjecting it to John's 22% marginal federal income tax rate, plus 5% for state income tax. The increased K-1 amount would also be eligible for the Sec. 199A 20% deduction whereas any additional salary would *not* qualify. So, this 27% marginal income tax rate, in reality, is equivalent to 21.6%. But, any contribution to the 401(k) plan would benefit from tax-deferred accumulation, whereas additional salary would probably have to go into a taxable investment account (unless there was another pre-tax deferral opportunity available such as putting the additional salary amount into health savings account).

Comment: With the annual 401(k) contribution limit rising, some individuals might feel pressure to put more money into retirement savings. However, most people are *not* contributing up to the 401(k) limit anyway. A recent Vanguard report found that only 14% of people with Vanguard 401(k) accounts were contributing the maximum amount allowed. This was in spite of the fact that the majority (58%) of those people were making more than $150,000 annually.

- SIMPLE IRA going from $14,000 to $15,500

- SIMPLE IRA catch-up going from $3,000 to $3,500

Example: "Maximum Deferral with SIMPLE IRA"
John is the sole owner and employee of his S corporation and is over 50 years of age. But instead of a "Solo 401(k)" he decides to set up a SIMPLE IRA. As opposed to a maximum deferral cap of $66,000, he is now faced with the maximum that he can contribute to the SIMPLE IRA being capped at just $19,000 (which is not even close to the $30,000 that a non-owner employee could put away in a 401(k) plan). Furthermore, the maximum employer match is capped at just 3% (v. 25% for the "Solo 401(k) plan").

- IRA contribution limit going from $6,000 to $6,500

Comment: The IRA limit was stuck at $6,000 since 2019, but the steep inflation that we have experienced lately finally gave it a boost. Nevertheless, the additional IRA "catch-up" contribution for people 50 and over is *not* subject to an annual cost-of-living adjustment and stays at $1,000 for 2023 (for a total 2023 contribution limit of $7,500 if you are at least 50 years old).

☞**<u>Defaulting on Retirement Plan Loans Can Result in Taxable Distribution</u>**

Loans made from a qualified retirement plan (e.g., 401(k) or 403(b) plan) are generally tax-free as long as the amount borrowed does not exceed the *lesser* of $50,000 or 50% of the account balance. This upper limit increases to the *lesser* $100,000 or 100% of the account balance for “disaster related loans” (which are distinguishable from “disaster distributions” which have a $22,000 cap). The maximum repayment period for plan loans is normally five years. But loans used to buy or construct a *principal* residence are granted a longer repayment period. Principal repayments on such loans must be made at least quarterly (with the interest amounts you are paying to yourself essentially being treated as nondeductible consumer interest). If you fail to pay back in at least quarterly installments, and this is *not* rectified by the end of the following quarter, then any unpaid loan balance remaining, plus interest, will be treated as a deemed taxable distribution (which can also be subject to the 10% early-withdrawal penalty). **(Misc.; Retirement Plan Loans)**

> **<u>Comment</u>:** Retirement plan loans continue to be a high-priority item for IRS auditors, especially where a **<u>Form 1099-R</u>** has been issued by the plan administrator (and, which the Service is also receiving a copy for matching purposes) treating the unpaid loan balance as a deemed distribution.

☞**<u>Retirement Funds Not Always Exempt from Creditors in Bankruptcy</u> (<u>*Lerbakken*, No. 18-6018, Bankruptcy App. Panel (8th Cir., 10/16/2018)</u>)**

Pursuant to a divorce decree, the taxpayer was awarded his ex-wife’s interest in her entire IRA, along with half of her 401(k) plan. He later was forced to file for bankruptcy and attempted to shield these assets from his creditors. But, since these retirement plan assets were acquired in a divorce, the exemption normally accorded such assets was *not* available. The bankruptcy court agreed, stating that the exemption for retirement plan assets is only applicable to the person that created and funded the accounts. **(Misc.; Bankruptcy)**

> **<u>Comment</u>:** A state bankruptcy exemption also does *not* prevent a federal tax lien from being executed. In a recent district court decision, the Service wanted to foreclose on a couple’s home to enforce a tax lien, but the couple insisted that their home was protected by a state’s (here, MA) homestead exemption. But, the court agreed with the IRS that the state bankruptcy exemption had no effect on the federal tax lien. There was also no bankruptcy stay in place to halt the foreclosure process. **(<u>*Seeley*, No. 16-cv-10935-ADB (DC, MA; 11/8/18)</u>)**

<u>Code §61 - Gross Income</u>:

☞**Parents Taxed on Funds Daughter Stole from Their Retirement Accounts (*Gomas*, 8:22-cv-1271-TPB-TGW, (D.C., Fla., 7/23/23))**

The couple’s daughter convinced them that she was in dire need of funds in order to fight a fictitious legal battle. Coming to her rescue, the couple withdrew $1.1 million in IRA and pension funds in 2017 and turned the money over to her. They later found out about this phony claim in 2019. Nevertheless, the couple insisted that they should *not* be taxed on their retirement distributions because they “did *not* enjoy the benefit of those funds.” A district court emphasized that it was unjust for the couple to owe taxes on these funds which had been stolen from them, but there was nothing the court could do for the couple. Since they received the payouts from the retirement accounts, they are responsible for any taxes owed on these distributions (i.e., as reported to the IRS on **Form 1099-R**. **(<u>Code §401</u>; Retirement Accounts)**

☞**IRS Matching Form 1099-R to Reported Distributions on Form 1040 (*Larochelle*, TC Summ. Op. 2022-12 (7/12/2022))**

The Service is getting tougher on taxpayer failures to report large IRA distributions on their personal returns. Its automated underreporting program matches data on information returns, such as **Form 1099-R**, with income amounts actually reported on individual tax returns. If there is a significant mismatch, the agency will contact the taxpayer to the issue by sending out a computer-generated **CP2000** notice. In this instance, a couple failed to report $238,000 in IRA distributions shown on **Form 1099-R**. The Service examined the couple's 2017 joint federal income tax return. It then issued a notice of deficiency dated January 6, 2020, and determined a deficiency of $72,177 and a **Code §6662** accuracy-related penalty of $9,075 for 2017. Petitioners timely filed a Petition for redetermination pursuant to **Code §6213(a)**. Eventually, they conceded in Tax Court that they did indeed owe the additional taxes and penalties. **(Code §61; Form 1099-R)**

> **Comment:** Not receiving **Form 1099-R** does *not* serve to negate an accuracy-related penalty. The couple in this case may have conceded the tax, but insisted that they should not owe the 20% fine imposed by the IRS for substantial understatement of income. Their position was that they did *not* remember ever receiving the **Form 1099-R** from the IRA custodian. Even though certain tax information forms are not received, it does *not* abrogate the couple's duty to report income and pay tax on the IRA payout.

Code §72(t) - Early Withdrawal Penalty:

☞**Tax Consequences of Early Withdrawals from IRAs & Retirement Plans**

Early retirement payouts from both IRAs and qualified retirement plans (i.e., 401(k) and 403(b) plans) are increasingly becoming an IRS audit target. One of the key factors is that the Service has a "paper trail" on **Form 1099-R** which alerts them as to these distributions and also the amount. As a result, IRS computers are looking for the correct treatment on these payouts on the recipient's personal return, based on the "code" listed on the information return.

A 10% additional tax (i.e., even though it's labeled a "early withdrawal penalty" by most practitioners) impacts most pre-age-59½ distributions. This additional excise tax on early distributions is in addition to any regular income tax that is otherwise due.

Nevertheless, there are a number of exceptions which serve to spare the account owner from paying this additional tax. Some apply to both IRAs and 401(k)s. Others only pertain to one or the other. Furthermore, some of the exceptions are newer, being enacted by Congress as part of the **SECURE 1.0 Act** in Dec. 2019, and the **SECURE 2.0 Act** late last year.

Below is a summary of these "exceptions" which tax professionals should inquire about when reviewing any **Form 1099-Rs** that the client has received for the most recent tax year.

- Disaster Related Distributions: Early withdrawals from IRAs and 401(k)s by disaster victims are penalty-free on up to $22,000 per disaster. There is a time limit: The payout must generally be taken within 179 days of the date the disaster is declared. The deadline was June 27, 2023, for federally declared disasters that arose on Jan. 26, 2021, through Dec. 28, 2022.

- Extraordinary Medical Expenses: Both IRAs and 401(k)s can be used to pay "extraordinary medical expenses" (i.e., that portion of the overall cost which exceeded 7.5% of the taxpayer's AGI for the year in question) without penalty. The money must be used for "qualified medical expenses" (i.e., as defined in **Code §213**) of the taxpayer, spouse or dependent. Moreover, the distributed funds must cover costs actually paid in the *same* tax year that the withdrawal occurred.

- Substantially Equal Payments: Taking substantially equal payments from an IRA or 401(k) is also a key exception to the 10% penalty. But distributions must continue for the *longer* of five years or until the recipient reaches age 59½. Withdrawals are required to be based on the owner's life expectancy or the joint life expectancy of the owner and named beneficiary. If the account owner modifies the annual payment amount, *all* previous distributions taken from that account will be subject to the 10% penalty.

- Other Exceptions: Included among the other 401(k) and IRA exceptions to the 10% penalty are the following:

(1) Terminal illness, permanent disability or death of account owner

(2) Some beneficiaries of deceased owners

(3) IRS levies on retirement funds

(4) Individuals having a baby or adopting can take up to $5,000 each for such costs

(5) Starting in 2024, up to $10,000 can be taken penalty-free by domestic abuse victims

(6) Early payouts from IRAs to assist "first-time" home buyers are penalty-free

> **Comment:** A "first- time homebuyer" is an individual who, with his or her spouse if married, has *not* owned any other principal residence for three years prior to the date of purchase of the new principal residence for which the credit is being claimed. This would include buying or building a main home or one for a spouse, kid, grandchild, parent or grandparent.

(7) Cost of higher education such as college tuition, computers, books, and room and board for students enrolled at least half-time. There's no dollar cap, but to qualify for the exception, the early distribution must cover education costs for the IRA owner, spouse, child or grandchild that are actually paid in the same year of the withdrawal.

(8) Unemployed individuals can use IRA funds to buy health insurance in some cases

> **Comment:** The "exceptions" listed in numbers (6), (7) or (8) above only apply to funds extracted from an IRA and *not* from qualified plans (e.g., 401(k) and 403(b)).

(10) Workers who withdraw their funds (i.e., as opposed to merely rolling over any balance into their IRA) upon leaving their jobs in the year they turn 55, or later. Their early 401(k) or 403(b) withdrawals are *not* subject to this 10% penalty. The age is 50 for public safety officers.

(11) Payments to an ex-spouse from a qualified plan as long as they are pursuant to a "qualified domestic relation order" (QRDO)

> **Comment:** The QDRO exception does *not* apply to IRA funds paid to an ex-spouse in a divorce.

> **Comment:** There are a number of other "exceptions" to this 10% early withdrawal penalty that mostly deal with distributions related to the COVID-19 pandemic. Furthermore, although taxable in the year of withdrawal, they can be repaid within 3 tax years with the account owner being able to file an amended return for any taxes paid. **(Code §72(t); 10% Early Withdrawal Penalty)**

☞**<u>"Early Withdrawal Penalty" in Reality Constitutes a Tax</u> (*Grajales*, Docket No. 21-1420 (2nd Cir., 8/24/2022))**

The 10% additional tax on early withdrawals is in fact a tax, an appeals court rules. This 2nd Circuit decision *affirms* a 2021 Tax Court decision. In that case, a 42-year-old woman who took a distribution from her retirement plan insisted that the 10% levy was a "penalty or other amount" which would have required prior written IRS supervisory approval. The appeals court rejected her claim, agreeing with the Service that the levy is a "tax and *not* a penalty, addition to tax or an additional amount." As a result, prior written supervisory approval is unnecessary. **(Code §72(t); 10% Early Withdrawal Tax)**

☞**<u>Exception to 10% Early Withdrawal Penalty to Pay Medical Expenses</u> (<u>*Salter*, TC Memo. 2022-29 (4/5/2022)</u>)**

There is some confusion about the exception to the 10% penalty for pre-age-59½ distributions where you are otherwise using funds from a retirement account to pay medical costs. To qualify as penalty-free, (1) the money must be used for medical costs of the taxpayer, spouse or dependent; (2) the funds must cover expenses *actually paid* in the year of the withdrawal; and (3) only the amount of medicals that exceeds the 7.5% of AGI threshold qualifies. This penalty relief, however, applies regardless of whether a taxpayer itemizes their deductions or chooses instead to take the standard deduction. In this recent case, an individual who took an early distribution from his qualified retirement plan (i.e., 401(k) or 403(b) plan, or an IRA) to allegedly help pay for his medical costs. But it did *not* qualify for the 10% penalty exception because his total medical expenses did *not* exceed the 7.5% AGI floor. **(<u>Code §72(t)</u>; Early Withdrawal Penalty)**

> **<u>Comment</u>:** Remember to distinguish situations where the taxpayer is instead using a "health savings account" (HSA) to cover medical. There, such costs *not* only include those actually incurred in the year the HSA distribution occurs, but *any* such costs since the tax year that the HSA was first set up. And, there is no rule that only the amount that exceeds the 7.5% of AGI threshold qualifies.

☞**Retirement Funds Must Be Paid to Ex-Spouse Directly Pursuant to QDRO (*Rosenberg*, TC Memo. 2019-124 (9/19/2019))**

When retirement funds are involved in a divorce property settlement, the rules can be complex, resulting in unwanted taxes and a possible penalty to the recipient ex-spouse. The family court will draw up a "qualified domestic relations order" (QDRO) and have the clerk of the court forward to the administrator handling the transfer of the funds. At this point, there are two distinct choices that the recipient ex-spouse has to decide upon, especially if they are *not* yet age 59½. If they received the funds directly, the monies will be taxable but they will *not* be subject the **Code §72(t)(2)** "10% penalty for early withdrawals" (since they are being paid pursuant to a property settlement in a divorce proceeding). On the other hand, if they direct the monies to be transferred to an IRA (either existing, or a newly-created account), then any subsequent withdrawals will be subject to the penalty unless a specific exception exist (e.g., first-time home purchase, extraordinary medical expenses, etc.).

Here, the ex-husband thought he had to set up a new IRA account at Merrill Lynch where his ex-wife had her IRA in order to receive these monies being paid out pursuant to the property settlement order (i.e., QDRO). But, he had no intention of retaining this account and promptly withdrew the monies within one week and closed the account. The brokerage firm then issued him a **Form 1099-R** for the withdrawal, but he failed to include this amount in his gross income, along with subjecting it to the 10% penalty. **(Code §72(t); Early Withdrawal Penalty)**

> **<u>Comment</u>:** The same result can occur upon the death of a spouse who was married to a "younger" person (i.e., someone *not* yet age 59½). If the surviving spouse intends to withdraw any

of the funds received, they should be held in a separate account and *not* co-mingled with an IRA, for instance, that they already have in place. Otherwise, not only would these withdrawn monies be taxed, but absent an exception under **Code §72(t)(2)**, they will also be subject to the 10% early withdrawal penalty.

☞**401(K) Distribution for First-time Home Purchase Subject to "10% Early Withdrawal Penalty" (*Soltani-Amadi*, TC Summary Opinion 2019-19 (8/8/2019))**

A 401(k) distribution used for a "first-time home purchase" was subject to a 10% early withdrawal penalty because the exception to the additional tax for first-time home purchases only applies to distributions from IRAs (and *not* qualified retirement plans).

Comment: This is also true when making QCDs if the monies to be used are in a qualified retirement plan. If that was the case, the funds should first be transferred out of the plan and into an IRA before they are disbursed to the charity.

Background: Distributions from qualified retirement plans are subject to a 10% "early withdrawal penalty," unless an exception applies. (**Code §72(t)(1)**) And, 401(k) (or, 403(b)) plans are "qualified retirement plans." (**Code §4974(c)**) Meanwhile, **Code §7701(a)(37)** defines an "individual retirement plan" as an individual retirement account or annuity (commonly referred to as IRAs). The Tax Court agreed that, for **Code §72(t)** purposes, a 401(k) plan is *not* an individual retirement plan. (***Uscinski*, TC Memo 2005-124 (5/25/2005)**) as opposed to distributions from individual retirement plans used for a first-time home purchase which are *not* subject to the 10% additional tax. (**Code §72(t)(2)(F); Early Withdrawal Penalty**)

Comment: If the taxpayer could have rolled over the necessary funds from their qualified plan (401(k) or 403(b)) first into an IRA, and then distributed them out for the "first-time home purchase," the 10% penalty tax would *not* have applied.

☞**Threat of IRS Levy No Exception for 10% Penalty for Early Retirement Plan Withdrawals (Thompson, Case No. 18-cv-01675-JCS (DC CA, 8/30/2018))**

The district court confirmed that the mere threat of the IRS imposing a levy on one's retirement plan in order to satisfy outstanding tax liabilities does *not* provide an exception to the **Code §72(t)** 10% early withdrawal penalty. In this instance, a married couple who were under age 59½ withdrew over $1 million in order to pay their tax debts. After the IRS assessed the penalty, they countered that an exception existed because the IRS had threatened to levy the funds to pay several years of back taxes. However, because there was no actual levy in place, the couple owed over $100,000 because of the penalty. **(Code §72(t); Early Withdrawal Penalty)**

Comment: The IRS has a helpful **chart** listing withdrawals that escape the 10% penalty, such as a series of substantially equal payments that last for the longer of five years or until age 59½, and withdrawals that are made to cover "extraordinary medical expenses" (i.e., those which exceed the current 7.5% of AGI threshold). The chart also notes which exceptions apply to 401(k)s and other qualified plans; those only for IRAs, SIMPLEs and SARSEPs; and which ones apply to all plans.

☞**Husband's Transfer to Ex-Wife of IRA Funds Resulted in 10% Early Withdrawal Penalty (*Summers* , TC Memo 2017-125 (6/27/2017))**

A husband and wife decided to get divorced without involving lawyers. During the settlement process, the husband believed that his IRA should be split 50-50 with his wife. As a result, he took an early distribution from his IRA and gave half of it to his wife before the divorce was finalized. The IRS issued a notice of deficiency to the husband for the 10% early distribution penalty, and he argued that his ex-wife was liable for the penalty on the portion of the IRA proceeds received by her. The Tax Court disagreed, holding that the husband was liable for the entire amount of the penalty. The exception under **Code §72(t)(2)(C)** was *not* available because the distribution was *not* made "pursuant to a qualified domestic relations order." **(Code §72; Early Withdrawal Penalty)**

> **Comment:** He would also be liable for the income taxes involved with the distribution since the funds came to him first (and, he would be the one issued a **Form 1099-R**).

☞**Higher Educational Expenses Must Be Paid in Same Year as IRA Distribution to Avoid 10% Penalty on Early Withdrawals (*Duronio*, TC Memo. 2007-90)**

In yet another decision on this issue, qualified higher educational expenses paid in a year other than the year of an early IRA distribution meant that the entire amount was subject to the 10% penalty on early withdrawals. The case demonstrates how this rule continues to trap many parents of college students.

> **Comment:** Unlike IRA contributions that can be made for a tax year up until the filing of a return, there is no "grace period" for the same-year rule for IRA withdrawals and tuition payments. Numerous taxpayers are getting caught in this trap, meaning that besides the income tax bite being taken out of their distributed IRA monies, they are getting hit with an additional 10% penalty tax. Here, the mother who was trying to help out her son with his tuition bill for college had to pay an extra $2,000 in taxes.

Code §105 - Health Reimbursement Arrangements:

☞**Regs for Health Reimbursement Arrangements Finalized (TD 9867)**

The IRS, along with the Departments of Labor (DOL) and Health and Human Services (HHS), has issued final rules that allow integrating health reimbursement arrangements (HRAs) and other account-based group health plans with individual health insurance coverage or Medicare, if certain conditions are satisfied (i.e., individual coverage HRA). The final rules also set forth conditions under which certain HRAs and other account-based group health plans will be recognized as "limited excepted benefits."

> **Comment:** Although we might be experts in general tax law areas, we might not work intensely in the fringe benefit or retirement plan area on a day-to-day basis. Nevertheless, there is no reason why we cannot have some awareness when important changes are made and at least know to seek out additional input for our clients' planning needs.

> **Comment:** These regs apply to tax years beginning after 12/31/19.

Background - Health Reimbursement Arrangements (HRAs): An "account-based group health plan" is an employer-provided group health plan that provides for reimbursement of expenses for medical care, subject to a maximum fixed-dollar amount of reimbursements for a period (e.g., a calendar year). An HRA is a type of account-based group health plan funded solely by employer contributions (i.e., with no salary reduction contributions or other contributions by employees) that reimburses an employee solely for medical care expenses incurred by the employee, or the employee's spouse, dependents, and children who, as of the end of the tax year, have *not* attained age 27, up to a maximum dollar amount for a coverage period. The reimbursements under these types of arrangements are excludible from the employee's income and wages for Federal income tax and employment tax purposes. And, amounts that remain in the HRA at the end of the year often may be used to reimburse medical care expenses incurred in later years, depending on the terms of the HRA. Account-based group health plans also include other arrangements, for example, health flexible spending arrangements (health FSAs).

Background - Affordable Care Act (ACA): The **Affordable Care Act** added **Code §9815(a)(1)** to incorporate the provisions of **Part A of Title XXVII of the Public Health Service Act (PHSA)** into ERISA and the Code, and make them applicable to group health plans and to health insurance issuers providing health insurance coverage in connection with group health plans. Under **Code §4980D**, an excise tax is imposed on failures to meet these requirements.

Among the ACA provisions applicable to group health plans are the "annual dollar limit prohibition" (i.e., annual limit), which prohibits a group health plan (or, a health insurance issuer offering group health insurance coverage) from establishing *any* annual limit on the dollar amount of benefits for *any* individual. (**PHSA §2711**) Also applicable are "preventative services requirements," which require non-grandfathered group health plans (or, health insurance issuers offering group health plans) to provide certain preventative services without imposing any cost-sharing requirements for the services. (**PHSA §2713**)

Under the ACA, the **Health Insurance Portability and Accountability Act**, and other statutes, both the Code and ERISA subject group health plans to a variety of requirements. However, these requirements generally do *not* apply to "excepted benefits," including limited excepted benefits that:

a. Are provided under a separate policy, certificate, or contract of insurance, or

b. Are otherwise *not* an integral part of the plan. (**Code §9831(c)(1)**)

Specifically, the benefits offered separately from a group health plan that may be "excepted" are:

1. Limited scope vision and dental benefits (**Code §9832(c)(2)(A)**);

2. Benefits for long-term care, nursing home care, home health care, or community-based care, or any combination of those benefits (**Code §9832(c)(2)(B)**); and

3. Other similar, limited benefits as specified in the regs. (**Code §9832(c)(2)(C)**)

2018 Proposed Regs: The Departments issued proposed regs that would allow an individual coverage HRA to be integrated with individual health insurance coverage or Medicare. The combined coverage would allow the HRA to satisfy the annual limit and preventative service requirements, under certain circumstances. The proposed regs also proposed expanding the definition of "limited excepted benefits" under **Code §9832(c)(2)**, to recognize certain excepted benefit HRAs. (**Prop. Reg. §54.9831-1**)

In addition, the proposed regs included rules on premium tax credit (PTC) eligibility for individuals covered under an individual coverage HRA integrated with individual health insurance coverage. An individual is eligible for the PTC for a month if the individual meets various requirements (i.e., a "coverage month"). Among other things, under **Code §36B(c)(2)**, a month is *not* considered to be a "coverage month" for an individual if either:

1. The individual is eligible coverage under an eligible employer-sponsored plan and the coverage is "affordable and provides minimum value" (MV); or

2. The individual is enrolled in an "eligible employer-sponsored plan," even if the coverage is *not* affordable or does *not* provide MV.

An “eligible employer-sponsored plan” includes coverage under an insured or self-insured group health plan and is “minimum essential coverage” (MEC) unless it consists solely of “excepted benefits.”

The proposed regs provided that an employee who is offered, but opts out of, an HRA integrated with individual health insurance coverage, and an individual who is offered such an HRA because of a relationship to the employee (i.e., a “related HRA individual”), are eligible for MEC under an “eligible employer sponsored plan” for any month the HRA is “affordable and provides MV.” As a result, these individuals would *not* be eligible for the PTC for their Exchange coverage for months the HRA is affordable and provides MV. (**Prop. Reg. §1.36B-2**)

The proposed regs also addressed the circumstances in which an HRA is considered to provide MV and would clarify the ways in which the generally applicable employer-sponsored coverage PTC eligibility rules apply to HRAs integrated with individual health insurance coverage.

In addition, the DOL proposed a clarification to provide plan sponsors with assurance that the individual health insurance coverage premiums reimbursed by an HRA and other account-based health plans or a qualified small employer health reimbursement arrangement (QSEHRA) does *not* become part of an ERISA plan, provided certain conditions are met.

HHS proposed regs that provided a special enrollment period in the individual market for individuals who gain access to an HRA and other account-based group health plans integrated with individual health insurance coverage or who are provided a QSEHRA.

2019 Final Regs: The various Departments mentioned above have now finalized the proposed regs. The final regs largely adopt the proposed regs with some modifications. Like the proposed regs, the final regs allow integration of individual HRAs with individual health insurance coverage and Medicare. (**Reg. §54.9802-4**) As a result, an employer that does *not* provide group health insurance to its employees may offer an individual HRA that will satisfy the requirements for MEC as long as certain conditions are met.

Generally, an HRA must require the participant (and, any dependents) to be enrolled in individual health insurance that is subject to, and complies with, the prohibition on annual payout limits and required preventative services rules. (**Reg. §54.9802-4(c)(i)**) In addition, the HRA must provide that it will *not* reimburse medical expenses incurred by the participant *after* the individual health coverage ceases. (**Reg. §54.9802-4(c)(ii)**) The HRA plan sponsor must verify the participant's individual health insurance coverage with each request for reimbursement and can rely on substantiation provided by the participant (**Reg. §54.9802-4(c)(5)**)

Furthermore, a plan sponsor may *not* offer a choice between an individual coverage HRA and a traditional group health plan to any participant (or, dependent). (**Reg. §54.9802-4(c)(2)**) Also, an individual coverage HRA must be offered on the *same* terms to *all* participants in the *same* class. The final regs add “restriction class size” but allow additional class types. (**Reg. §54.9802-4(c)(3)**) However, there may be a variation in the terms due to the number of participant's dependents covered (**Reg. §54.9802-4(c)(3)(A)**) or the participant's age. (**Reg. §54.9802-4(c)(3)(B)**)

Under the final regs, a participant must be allowed to opt out of coverage *before* the beginning of the plan year. (**Reg. §54.9802-4(c)(4)**)

The final regs retain the proposed rule that an employee and a related HRA individual are *not* eligible for the PTC any month the employee is offered an individual coverage HRA that is affordable and offers

MV, even if the employee opts out of the arrangement. (**Reg. §1.36B-2**)

The final regs also define "essential health benefits" and how HRAs can be used once they are integrated with individual health insurance. (**Reg. §54.9815-2711**)

> **Comment:** The IRS has also released **Notice 2019-45** expands upon previous guidance (**Notice 2004-23**, **Notice 2004-50** and **Notice 2013-57**) by providing an appendix with a limited list of additional "preventive care services" and items for certain "chronic conditions" that may be treated as preventive care for purposes of **Code § 223(c)(2)(C)**. These additional services and items are treated as "preventive" only when prescribed to treat an individual "diagnosed with the specified chronic condition," and only when prescribed "for the purpose of preventing the exacerbation of the chronic condition or the development of a secondary condition."

Effective Dates: The regs are effective on August 19, 2019. They generally apply for plan years beginning *on or after* January 1, 2020. However, the final rules under **Code §36B** apply for taxable years beginning *on or after* January 1, 2020, and the final rules providing a new special enrollment period in the individual market apply January 1, 2020. **(Code §105; HRAs)**

Code §125 - Cafeteria Plans:

☞Unused Transportation Benefits Could Not Be Transferred Over to FSA (Info. Ltr. 2022-0002)

The IRS has confirmed through a private letter ruling that unused transportation benefits that this employee had previously received could *not* be transferred over to a health FSA. In this instance, the employee received pre-tax parking benefits through his employer but was now permanently working from his home because of the coronavirus pandemic. As a result, he no longer needed the benefits and wanted to transfer the unused funds to his health flexible spending arrangement. **(Code §125; FSA)**

> **Comment:** This same result has been seen in several cases where an employee leaves their job and requests a refund of monies that they have previously set aside in their flexible spending account. It basically becomes a "nonrefundable deposit" that cannot be returned to the employee. The same is true where significant amounts were set aside in a **Code §129** "dependent care assistance" program administered by an employer and the employee finds themselves now caring for the child at home when the daycare center was closed during the coronavirus pandemic.

☞Death of Ex-Spouse Was Not Cafeteria Plan "Change in Status" (Info. Ltr. 2019-0013)

This IRS "information letter" concluded that the death of a *former* spouse is *not* to be treated as a "change in status" for **Code §125** cafeteria plan purposes. Therefore, the surviving ex-spouse, who was providing health benefits via a cafeteria plan to the decedent because of a court order, was *not* permitted to change plan benefits in the middle of the plan year (i.e., they had to effectuate the change for the following plan year).

Background: A **Code §125** cafeteria plan is a plan where no amount is includible in the gross income of a participant in the plan solely because the participant can choose among the benefits they receive from the plan. (**Code §125(a)**) Generally, a **Code §125** cafeteria plan requires that an employee elect benefits *before* the beginning of the plan year (i.e., election period). (**Prop. Reg. §1.125-2(a)**) As a result, the employee cannot change the election during the plan year unless a "change in status" occurs. (**Reg. §1.125-4(c)**) One event that is considered to be a "change in status" is when there is a change in the number of an employee's dependents. (**Reg. §1.125-4(c)(2)(ii)**) In general, a "dependent" means a qualifying child or qualifying relative. (**Code §152(a)**)

A former spouse is *not* a "dependent" as defined under **Code §152**. Therefore, as the IRS points out in this guidance, the death of a former spouse does *not* change the number of an employee's dependents and is *not* a change in status under the regs. On the other hand, **Reg. §1.125-4(d)(1)** does provide that a cafeteria plan may treat certain court orders requiring health coverage for an employee's child as a change in status. But, **Reg. §1.125-4(d)(1)** does *not* include as a change in status a situation in which the death of a *former* spouse effectively terminates the requirement to provide health coverage under a court order.

IRS Information Letter: In this instance, an employee specifically asked whether an election under a **Code §125** cafeteria plan, made pursuant to a court order to provide health coverage to his ex-spouse, entered in connection with the employee's divorce, can be changed upon the death of the former spouse. In response, based on the analysis above, this is *not* a "change in status." Therefore, the employee cannot change the election during the middle of a plan year. Instead, the employee must wait until the election period before the beginning of the *next* plan year to make any changes. **(Code §125; Cafeteria Plan)**

> **Comment:** The employee here wanted to reduce his monthly premium amount by only having to cover himself for the remainder of the tax year in which his ex-spouse died, but was denied. But, the death or divorce of a current spouse would have served as a "change in status" which would have allowed an adjustment in enrollment in the cafeteria plan.

Code §132 - Employer-Provided Fringe Benefits:

☞Service Releases Fringe Benefit Guide (IRS Pub. 15-B)

The IRS has released the 2023 final version of its **Publication 15-B (The Employer's Tax Guide to Fringe Benefits)**. The "What's New" section of the publication includes information on the 2023 business mileage rate under the "cents-per-mile rule," the monthly exclusion for qualified parking and commuter transportation benefits, and the contribution limit on a health flexible spending arrangement (FSA). There is also a table (on page 6) of the publication that summarizes the differences in the treatment of various fringe benefits for federal income tax withholding (FITW), Social Security and Medicare (FICA), and federal unemployment tax (FUTA) purposes. For example, payments from an employer's adoption assistance plan that meet certain requirements are *not* subject to FITW. However, the payments are subject to FICA and FUTA tax.

Qualified Parking Exclusion and Commuter Transportation Benefit: The monthly exclusion for both qualified parking and for commuter highway vehicle transportation and transit passes is $300 in 2023.

Contribution Limits for Health Flexible Spending Arrangements: A cafeteria plan may *not* allow employees to request salary reduction contributions to health FSAs greater than $3,050 in 2023. Employers must generally determine the value of noncash fringe benefits no later than January 31st of the next year. Before January 31, employers may "reasonably estimate" the value of the fringe benefits for purposes of withholding and depositing on time. Employers may be subject to a penalty if they underestimate the value of the fringe benefits and deposit less than the amount that they would have had to deposit if the applicable taxes had been withheld. On the other hand, if employers overestimate the value of the fringe benefit and over deposit, they may either claim a refund or have the overpayment applied to their next Form 941. **(Misc.; Fringe Benefits)**

Comment: IRS Pub. 15-B supplements **IRS Pub. 15, (Circular E) (Employer's Tax Guide)**, and

IRS Pub. 15-A (Employer's Supplemental Tax Guide).

☞**Free Plane Tickets for Retired Pilot's Relatives Taxable (*Mihalik*, TC Memo. 2022-36 (4/13/2022))** United Airlines' retiree benefits program including the awarding of free airline tickets on a stand-by basis to both retired pilots and their families. Here, a former pilot used this program a great deal for himself, his spouse and his daughter. There was no dispute that the value of these airplane tickets is nontaxable to him. But, the dispute with the IRS was whether he should be taxed on the value of free tickets for other relatives (which was reported by United Airlines on **Form 1099-MISC**). The Tax Court agreed with the Service that since the other relatives are *not* his dependents, their free tickets were not allowed to be treated as nontaxable fringe benefits. **(Code §132; Fringe Benefits)**

> **Comment:** So, when his daughter is no longer his dependent, even the value of her free tickets would become taxable to her father.

☞**IRS Clarifies Treatment of CPEO Payments to Self-Employed Individuals (CCA 201916004)** The IRS has offered guidance on the employment tax treatment of payments from Certified Professional Employer Organizations (CPEOs) to self-employed individuals (e.g., partners and Schedule C/F proprietors). In general, CPEO payments to self-employed individuals are *not* treated as "wages" for employment tax purposes. However, in the rare event the individual receives payments from the CPEO in two separate capacities (i.e., as a self-employed individual and a common law employee), the CPEO is treated as the employer for employment tax purposes with respect to the wages only. In addition, the CCA clarified that any payment made by a CPEO to a partner in a partnership must be treated and reported as a payment to a self-employed individual under **Code §6041**. **(Code §132; Fringe Benefits)**

> **Comment:** Despite the fact that some payroll companies will try to issue W-2s to these self-employed individuals, it does *not* change the fact that they are not "employees" and should, therefore, *not* be treated as such when it comes to tax-free fringe benefits.

Code §162 - Deduction for Deferred Comp:

☞**Tax Treatment of Deferred Comp on Sale of Business (*Hoops, LP*, TC Memo. 2022-9 (2/23/2022))** The taxpayer sold his business in 2012, in a transaction in which the buyer acquired most of the assets and assumed the seller's liabilities. This included $11 million in deferred compensation owed to two of the team's employees. The seller of the business attempted to take an $11 million deduction for the deferred pay on its 2012 tax return. Upon audit, the IRS denied the deduction with the Tax Court agreeing with the disallowance. Nonqualified deferred comp is only deductible in the year the employee actually includes the amount in their gross income. This applies even when the seller uses the accrual method of accounting. And, since no deferred payments were made to the employees in 2012 (i.e., the year in which the sale occurred), no current deduction was allowed. **(Code §162; Deferred Comp)**

Code §170 - Qualified Charitable Distributions:

☞**Handling QCDs and Other Distributions from Retirement Plans** Here is a brief synopsis of the respective tax rules and reporting guidelines when various types of distributions are made from a taxpayer's IRA.

> **Qualified Charitable Distributions:** If a "qualified charitable distribution" is made from a taxpayer's IRA in 2022, **Form 1099-R** will *not* specifically reflect the QCD. It will show only the

distribution amount because IRA custodians normally do *not* have firsthand knowledge to determine whether a particular payout from a traditional IRA satisfies the requirements in order to be classify as a QCD. When a taxpayer files their **Form 1040**, they must include the total amount of the IRA distributions shown on the **Form 1099-R** on **Line 4a**. The QCD amount is then subtracted from the total distribution with the remainder being listed on the taxpayer's **Form 1040**, even if $0, on **Line 4b**. In addition, the acronym "QCD" should be listed next to **Line 4b**.

Comment: If using tax preparation software, there should be a "drop-down box" for **Line 4** that offers a chance to indicate that this charitable contribution qualifies as a QCD.

Comment: Some brokerage firms such as Morgan Stanley and Charles Schwab offer a checkbook in connection with a customer's IRA. As a result, a check can simply be written directly to the intended charity by the taxpayer. This alternative of the funds flowing from the IRA via a check over to the charity will be treated as a QCD. And, there needs *not* be any coordination or working with the IRA custodian in carrying out the transaction.

Comment: Keep in mind that each spouse (i.e., on a MFJ return) is entitled to make up to a $100,000 QCD when filing **Form 1040**. Nevertheless, one spouse cannot contribute toward the other spouse's QCD.

Example: John has $70,000 available in his IRA to make a QCD for the current tax year. On the other hand his spouse Lisa has a $200,000 available in her IRA. She proceeds to make a $100,000 QCD in total to a variety of charitable organizations. Lisa cannot, however, transfer (or, make on John's behalf) an additional $30,000 donation in her spouse's name (i.e., so that he also maxes out on the $100,000 cap allowed).

Comment: Finally, despite some rumors that Congress would act to change the law, QCDs have to come out of an IRA and *not* a qualified retirement plan such as a 401(k) or a 403(b). So, if the QCD is going to be funded with qualified plan monies, then a tax-free rollover (as discussed below) must first be made from the plan to the taxpayer's IRA. Only then can the QCD be forwarded from the IRA to the charity.

Tax-free Rollovers: With regard to tax-free rollovers from a taxpayer's IRA, the reporting rules on **Form 1099-R** are similar (i.e., when compared to the QCD rules above). The amount that is rolled over from the IRA will be a part of the total distributions listed on the form (i.e., assuming that multiple distributions, including taxable ones were made throughout the year). As a result, when **Form 1040** is prepared, the taxpayer should include the *entire* amount of IRA distributions made during the tax year as shown on **Line 4a** of **Form 1099-R**. And, just as with any QCD amount, the tax-free rollover portion should be subtracted with the remainder, if any, being listed on on **Line 4b**. In addition, the label "Rollover" should be listed next on **Line 4b**.

Post-mortem RMDs: If an IRA owner dies *before* taking *all* of their RMD for the year, the required remaining amount for that tax year must still be extracted from the decedent's IRA. This distribution is generally paid to the beneficiary and *not* to the decedent's estate. Furthermore, the beneficiary has until Dec. 31st of the year of death to take that final RMD on behalf of the deceased owner, with the beneficiary being taxed on the distributed amount.

Comment: The year-of-death RMD amount is figured using **Table II** or **III** in **Appendix B** of IRS Pub. 590-B, based on the decedent's life expectancy and as if they had lived for the entire year.

Comment: Since the IRA in this instance would be inherited *after* the decedent's "required beginning date," the beneficiary would be entitled to a ten-year period in which to extract the remaining balance in the IRA (even to the point of the last day of the 10th year to do so). If, instead, the decedent died *before* their RBD, then the beneficiary would have to distribute the IRA balance during years one through nine based on their life expectancy (i.e., using the IRS tables mentioned above), with the remaining balance being taken out by the last day of the 10th year.

Comment: For the best reference books/guides written on IRAs and retirement plans you should Google "Ed Slott" or "Natalie Choate" and appreciate how much has been written by them with regard to tax planning for clients. **(Code §408; IRA Distributions)**

Code §223 - Health Savings Accounts:

☞**New 2023 Limit for Health Flexible Savings Accounts (Rev. Proc. 2022-38)**
For the tax years beginning in 2023, the dollar limitation for employee salary reductions for contributions to health FSAs increases to $3,050. For cafeteria plans that permit the carryover of unused amounts, the maximum carryover amount is $610, an increase of $40 from 2022. **(Code §125; Cafeteria Plans)**

Comment: Keep in mind that HSAs can be set up initially with tax-free rollover of IRA monies.

☞**Clarification of Premium Tax Credit Eligibility for Family Coverage (T.D. 9968)**
The IRS has issued final regulations under **Code §36B** that amend the regulations regarding eligibility for the Premium Tax Credit (PTC) (i.e., as calculated on **Form 8962**). The rule change provides that the "affordability of employer-sponsored minimum essential coverage" for *family* members of an employee is determined based on the employee's share of the cost of covering the employee as well as those family members "rather than the cost of covering only the employee." The final regulations do *not* change the "affordability test" for the employee who only has *individual* coverage. The final regulations also add a "minimum value rule" for family members of employees based on the benefits provided to the family members. **(Code §36B; Premium Tax Credit)**

Comment: This is intended to fix the so-called "family glitch," which prevents family members from receiving **Affordable Care Act** subsidies if a household member has access to employer-sponsored coverage that meets the law's requirements for affordability and coverage. The law requires that employer-sponsored plans be affordable only for employees, *not* for family members, although family coverage might indeed be unaffordable if the entire household is to be included.

Comment: More than 5.1 million people fall into the "family glitch," the Kaiser Family Foundation **estimates**. Meanwhile, the White House estimated nearly 1 million people would get more affordable coverage. On the other hand from an employer cost savings standpoint, the **Urban Institute** estimated that 585,000 people would now move out of employer coverage, decreasing employer spending by about $2 billion a year.

Comment: The proposal is **estimated** to cost more than $45 billion from 2020 to 2030, and White House **estimates** show it would lead to about 200,000 uninsured people gaining coverage.

Comment: These final regulations affect taxpayers who enroll, or enroll a family member, in individual health insurance coverage through a Health Insurance Exchange (Exchange) and who may be allowed a PTC for the coverage.

☞**Calculating Maximum HSA Contributions in First Medicare Year (Info. Ltrs. 2016-0003 & 2016-0014)**

The IRS has released two information letters explaining how to compute the maximum permissible HSA contribution in the first year an individual enrolls in Medicare. In **Information Letter 2016-0014**, an individual covered by a High Deductible Health Plan (HDHP) for *nine* months enrolled in Medicare. The IRS concluded that she would be allowed an HSA contribution of 9/12 of the maximum amount, plus a catch-up contribution of 9/12 of the maximum amount. **Information Letter 2016-0003** provides guidance and an example illustrating how to calculate the maximum HSA contribution for spouses who *both* turn 65 and enroll in Medicare during the *same* year, but in *different* months. **(Code §223; HSAs)**

> **Comment:** This is the same type of calculation that needs to be done when someone who has an established HSA, and to which annual contributions are made, marries a person who has subsidized health insurance under which both of them will now be covered. For instance, suppose that they got married on August 13th of the current tax year and the cap on contributions to an individual HSA is $3,350. Testing for eligibility to make contributions to an HSA is made as of the *first* day of each month. As a result, this new spouse would be eligible to make contributions on the first day of each month, including August, the month that they were married in the total amount of $2,234 (8/12 x $3,350) for that tax year. Once they now have health insurance through their new spouse, however, they would *not* be able to make any contributions for the remaining 4 months of the year.

☞**IRS Expands List of Permitted "Preventive Care Benefits" under HDHPs (Notice 2019-45)**

The IRS has expanded the list of "preventive care benefits" permitted to be provided by a High Deductible Health Plan (HDHP) under **Code §223(c)(2)** without a deductible, or with a deductible below the applicable minimum deductible (i.e., self-only or family) for an HDHP. The updated list includes medical care services and other items (such as prescription drugs) for certain chronic conditions. However, these additional services and items are treated as "preventive" only when prescribed to treat an individual "diagnosed with the specified chronic condition," and only when prescribed for "preventing the exacerbation of the chronic condition or the development of a secondary condition." **(Code §223; HDHPs)**

> **Comment:** The IRS will review the list of preventive care benefits every five to ten years to determine whether services or items should be added or removed from the list.

Code §401 - Required Minimum Distributions:

☞**Contributions for SEP-IRA Must Come from S/E Income (*Doberstein*, TC Bench Opinion 10557-21S (5/26/2022))**

The Tax Court has confirmed that in order to contribute to a SEP-IRA, you must have earnings from self-employment. In this instance, a self-employed engineer whose income from his business was minimal, was forced to take a full-time employee position with the government. Then, despite having no earnings from self-employment, he still contributed $5,500 to his SEP-IRA for the tax year in question. As a result, he was *not* allowed to deduct the contribution. **(Code §401; SEP-IRA)**

> **Comment:** Self-employeds have until Oct. 17, 2022 to set up and fund a SEP-IRA for 2021. Up to 20% of net self-employment earnings (i.e., gross amount of S/E earnings less one-half of the SECA tax liability). The overall cap is 20% on net self-employment earnings of $290,000 for 2021 and $305,000 for 2022.

☞**Summary of Current Rules for RMDs**

Generally, taxpayers who were at least 73 years old by 12/31/2022 and have a retirement account (i.e., qualified retirement plan or IRA), are required to withdraw minimum amounts annually. There are a few waivers and other rule changes.

Taxpayers Still Working: For taxpayers with retirement plans provided by an employer, RMDs can be delayed for that particular plan if the account holder continues working and is *not* at least a 5% owner of that employer. But, again, this would only apply for that specific qualified plan sponsored by that particular employer. However, for taxpayers who do meet the applicable age criteria, they are nevertheless required to make annual withdrawals from traditional IRAs as well as from simplified employee pension plans (SEPs), savings incentive match plans for employees (SIMPLE) and salary reduction simplified employee pension (SARSEP) plans, even if they continue working.

> **Comment:** Keep in mind that for this "5% ownership rule," the attribution rules will apply so that, for example, if the taxpayer's children take over the business, their ownership stake, if any, will be attributed back to their parents.

> **Comment:** Under none of the various rules being discussed here will a taxpayer be required to withdraw any funds from a Roth IRA. But, should their account be inherited by other family members (except their surviving spouse) they would have to commence RMDs (even though the amounts received from the Roth IRA would continue to be tax-free).

☞**10-Year "Clean-out Rule" for Inherited Retirement Plan Monies Varies Based on Decedent's RBD**

Practitioners have questioned the mechanics of the 10-year rule that became law as part of the **TCJA** and is effective for decedents dying after 2018. The key issue is whether amounts need to be paid out each year? Or, can the beneficiary wait until year 10 to drain the entire balance in the inherited retirement account or IRA? The answer is that "it depends."

If the deceased IRA owner died *before* their required beginning date (RBD) for taking required minimum distributions (RMDs), then distributions need *not* be distributed *evenly* over a 10-year period. Instead, beneficiaries can wait until year 10 to pull out the entire balance in the account, take annual payouts, or even skip some years, so long as the inherited retirement account or IRA is depleted within 10 years. On the other hand, if the deceased IRA owner died *after* their RMD beginning date, then annual RMDs must be paid to the beneficiary in years 1 through 9 (i.e., based on the IRS "mortality tables"), with the remaining balance in the account depleted by the end of the 10th year. **(Misc.; RMDs)**

☞**Avoiding 10% Early Withdrawal Penalty on Pre-59½ Plan Distributions (Notice 2022-6)**

Absent a few limited exceptions, an early withdrawal penalty normally applies to pre-59½ distributions out of IRAs or qualified plans such as 401(k) or 403(b) plans. One of the exceptions is to extract "substantially equal periodic payments" from the IRA or retirement plan. Such distributions must extend until the *later* of 5 years or until age 59/½ is reached. Withdrawals must be based on the owner's life expectancy or the joint life expectancy of the owner and the designated beneficiary. However, if the distributions vary substantially from year to year, all distributions to-date will be subject to the 10% penalty. **(Code §72(t); 10% Early Withdrawal Penalty)**

> **Comment:** "Vary substantially" could include situations where a required payment was missed during this period of "must extend until the *later* of 5 years or until age 59/½ is reached."

Notice 2022-6: This IRS notice provides detailed information on the three distinct methods then extracting the funds in order to avoid any penalty as follows:

1. Required Minimum Distribution Method: The balance in the account should be divided by the number of years taken from the IRS "**life expectancy table**."

2. Fixed Amortization Method: Similar to the payment schedule for a mortgage, the required annual distribution is determined by amortizing the account balance over a specific number of years using the "life expectancy tables" and applicable interest rates.

3. Fixed Annuitization Method: The account balance is divided by an annuity factor and interest rate.

> **Comment:** For the most up-to-date life expectancy tables to be used to determine required minimum distributions, to **Appendix B** of **IRS Pub. 590-B**.
>
> **Comment: Notice 2022-6** replaces the guidance in **Rev. Rul. 2002-62** and **Notice 2004-15** for any series of payment beginning *on or after* 1/1/23. The guidance may also be used for a series of payments beginning in 2022.

☞**IRS Releases Updated Life Expectancy Tables for RMDs (TD 9930)**

These new life expectancy tables, which will now be used for required minimum distributions, were last updated in 2002 and account for more-current individual mortality rates. In other words, the revised tables will result in distributions being spread out over more years since life expectancies are now projected to be about one to two years longer than those listed in the existing tables. For example, a 72-year-old IRA owner currently uses a distribution period of 25.6 years to calculate RMDs. Under the new tables, a 72-year-old would use a longer period of 27.4 years. By basing RMDs on longer life expectancies, plan participants and IRA owners will be able to take out *smaller* annual payouts while providing for longer tax-deferral of assets held in these accounts. The updated tables apply to computing withdrawals for 2022 and beyond, even for those people who have been using a shorter life expectancy in prior years. **(Code §401(a)(9); RMDs)**

☞**Plan Loans Main Target of IRS Audits**

IRS agents have made it clear that they are looking for abusive loan arrangements when they audit retirement plans. As part of an audit, the Service examines how plans handle loans, such as the time allowed for repayment, and what happens on default. Field auditors request copies of signed loan agreements and promissory notes, as well as documentation to substantiate residential loans. Audit results reveal that the common plan loan failures include: (1) Loan amounts over the statutory cap; (2) Nonresidential loans in which the repayment period exceeds the maximum five years; and (3) Loan defaults, in which the participant fails to make the required payments. **(Misc.; Retirement Plan Audits)**

> **Comment:** Small businesses have many different options when helping workers save for retirement. These include SEPs, SIMPLE IRAs, payroll deduction IRAs, profit-sharing plans, 401(k)s and pensions. There is useful IRS **publication** that compares the employer's role, contribution limits, eligibility, withdrawals, vesting and other basic operational rules.

☞**Retirement Plan Cannot Be Forced to Offer Loans to Participants (Info. Ltr. 2019-0004)**

The IRS has advised that while the Code imposes certain requirements on qualified employer plans that offer loans to participants, such plans do *not* have to offer loans at all. And, even if they do, they may restrict them to certain situations. As a result, the IRS cannot force a plan to offer loans or stop a plan from imposing certain restrictions on loans.

Background: The laws relating to qualified employer plans impose various limitations on the permissibility of loans and distributions from those plans. For example, **Code §401(k)(2)(B)(i)** provides that in the case of a **Code §401(k)** plan that is part of a profit-sharing or stock bonus plan, elective deferrals may be distributed only in certain situations, one of which is on account of hardship.

In order to make a loan or distribution (including a hardship distribution), a plan must contain language authorizing the loan or distribution. A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless: **(CARES Act increases these limits to $\geq$ \$100,000 or 100% of vested benefits under the plan, but only for loans taken out in 2020)**

1. The loan amount does *not* exceed the lesser of:

   i. \$50,000, or

   ii. One-half of the present value of the employee's nonforfeitable accrued benefit under the plan.

However, a loan up to \$10,000 is allowed, even if it's more than half the employee's accrued benefit. (**Code §72(p)(2)(A)**)

2. The loan is required to be repaid within five years, (**Code §72(p)(2)(B)(i)**) except that a longer repayment can be used for a “principal residence plan loan” (i.e., a loan used to acquire any dwelling unit which, “within a reasonable time,” is to be used as the participant's *principal* residence; (**Code §72(p)(2)(B)(ii)**)

3. Except as provided in the regs, the plan loan is amortized in “substantially level payments,” made *not* less frequently than quarterly; and (**Code §72(p)(2)(C)**)

4. The loan is evidenced by a legally enforceable agreement. (**Reg. §1.72(p)-1, Q&A 3**)

Comment: Corona virus distributions which allow up to \$100,000 in plan loans only applies until 12/31/20.

Early (generally, pre-age 59½) withdrawals from a qualified retirement plan result in an additional tax (i.e., penalty) equal to 10% of the amounts withdrawn that are includible in gross income. (**Code §72(t)(1)**) The additional tax applies unless the taxpayer qualifies for one of several specific exceptions. (**Code §72(t)(2)**, **Code §72(t)(3)**) There is no exception for “hardship withdrawals.” A similar rule applies to distributions from an IRA.

Plan provisions and regs under certain Code sections establish verification procedures that a plan must follow before loans or distributions can be made from the plan. For example, the regs under **Code §401(k)** set forth certain criteria an employee must meet in order to receive a “hardship distribution.” A plan may contain procedures designed to confirm that the criteria have been satisfied.

IRS Ruling: In this Information Letter, which was a response to an question concerning obtaining a loan from the taxpayer's **Code §401(k)** plan, the IRS advised that it could *not* force a plan to offer loans or stop a plan from imposing certain restrictions on loans. The IRS noted it that it was *not* necessarily the Code that prevented the taxpayer from getting a "hardship loan” from the plan. However, the IRS explained that plans do *not* have to offer loans to participants. And even if they do, they may restrict them to certain situations, such as where a "hardship" is involved.
Examples of this would be in cases such as medical expenses or student loans for plan owner or their dependents. But, again, it was up to the plan whether to include such features. Finally, the IRS advised that the taxpayer might want to contact the plan administrator to see if “hardship distributions” were available (even if “loans” generally were not). **(Code §401; Pension Plan Loans)**

☞**Tax Options Where Nonspouse Roth IRA Beneficiary's Fails to Begin Taking RMDs (Info. Ltr. 2016-0071)**

Normally the required minimum distribution rules of under **Code §401(a)(9)(A)** do *not* apply to Roth IRAs during the owner's lifetime. Nevertheless, post-death distributions must be made according to the RMD rules as if the Roth IRA owner died *before* their required beginning date. This IRS memo addresses whether a nonspousal beneficiary's failure to begin RMDs *within one year* of the Roth IRA owner's death made the "life expectancy rule" inapplicable and, as a result, required that distributions be made under the alternative "five-year rule." The IRS explained that RMDs must be made according to the "life expectancy rule" unless the plan (1) requires distributions to be made under the five-year rule or (2) allows the beneficiary to elect the five-year rule, and the beneficiary timely makes the election. The bottom line is that the "applicable distribution period" is based on these specific rules and *not* on whether distributions were timely received. **(Code §401; RMDs)**

> **Comment:** Although the Roth IRA distributions continue to be tax-free to a non-spousal beneficiary, the funds in the account are subject to the RMD rules.

☞**Required Minimum Distributions for Qualified Plans Cannot Be Satisfied With IRA Withdrawals (PLR 201406023)**

Even though a SEP withdrawal can be used to meet the required minimum distribution from an IRA, such a withdrawal cannot be used to meet the RMD from a qualified retirement plan. In this instance, the taxpayer was told by his financial adviser that he could tap his SEP for the *total* mandatory withdrawal from the SEP, his IRA and the balance in his qualified plan and he subsequently took that advice. Then, more than 60 days after he made the SEP withdrawal, he found out that the advice was wrong when the retirement plan administrator made him take the required annual payout from the plan. And, the trustee of the SEP refused to allow him to reverse the excess distribution. Nevertheless, the IRS came to the rescue and allowed the owner of the SEP do a late rollover back into that IRA account of the excess payout. In this private letter ruling, the Service waived the 60-day rule because the taxpayer had relied on the erroneous advice of a financial professional. The bottom line is that he did *not* owe any tax on the amount of the excess withdrawal from the SEP. **(Code §408(d)(3); RMD)**

Code §402 - Taxation of Beneficiary of Employee's Trust:

☞**Proposed Regs Govern Qualified Plan Loan Rollovers (REG-116475-19)**

These regs address the amendments to **Code §401(c)** by **Sec. 13613** of the **Tax Cuts and Jobs Act**, which provides an "extended rollover period" for a "qualified plan loan offset." **Code §72(p)(1)** provides that if, during any tax year, a participant or beneficiary receives (directly or indirectly) any amount as a loan from a qualified employer plan (defined under **Code §72(p)(4)(A)** which would include *both* defined contribution plans such as 401(k)s and 403(b)s, or a defined benefit plan), that amount will be treated as having been received by the individual as a distribution from the plan. For certain plan loans, **Code §72(p)(2)** provides an exception to the general treatment of loans as "distributions." But, for this exception to apply, the loan generally must satisfy three requirements:

- The loan's terms must satisfy the limits on loan amounts, under **Code §72(p)(2)(A)** (i.e., $50,000, except for Corona virus related loans which allow for higher limits under the **CARES Act**);

- The loan must be repayable within five years (six years for Corona virus related loans) ; and

- The loan must require substantially level amortization over the loan term (three years for Corona virus related loans).

The **TCJA** amended **Code §402(c)(3)** to provide an "extended rollover deadline" (i.e., as opposed to the normal 60-day rollover period) for qualified plan loan offset (QPLO) amounts. Any portion of a QPLO amount (up to the *entire* amount) may be rolled over into an eligible retirement plan by the individual's tax filing due date (including extensions) for the tax year in which the offset occurs.

Prop. Regs. §1.402(c)-3 takes into account these changes to the QPLO rollover rules. For instance, they state that a QPLO is a type of "plan loan offset." As a result, most of the general rules relating to plan loan offset amounts apply to QPLO amounts. In addition, the rules in **Regs. §1.401(a)(31)-1, Q&A-16** (which explains the offering of a direct rollover of a plan loan offset amount), and **Regs. §31.3405(c)-1, Q&A-11** (which contains special withholding rules for plan loan offset amounts), that apply to plan loan offset amounts in general also apply to QPLO amounts. The proposed regulations provide examples to illustrate the interaction of the special rules for QPLOs with the general rules for plan loan offsets.

Consistent with the **Code §402(c)(3)(C)** amendments, the proposed regs provide that a distribution of a plan loan offset amount that is an "eligible rollover distribution" and a QPLO amount may be rolled over by the employee (or spousal distributee) to an eligible retirement plan through the period ending on the individual's tax filing due date (including extensions) for the tax year in which the offset is treated as distributed from a qualified employer plan.

The proposed regs also contain definitions of "plan loan offset amount," "QPLO amount," and "qualified employer plan" and special rules for QPLO determinations when a severance from employment has occurred.

Effective Date: The rules will be effective when they are final, but taxpayers may rely on them with respect to plan loan offset amounts, including QPLO amounts, treated as distributed *on or after* Aug. 20, 2020, until the final regulations are issued. **(Code §402; QPLOs)**

Code §408 - Individual Retirement Accounts:

☞**60-Day IRA Rollover Rule Strictly Enforced (PLR 2020033088)**

Taxpayers need to be careful if they are considering taking a withdrawal from their IRA for short-term cashflow needs. The extracted funds have to be returned within 60 days or the distribution will be taxed, and possibly subject to the **Code §72(t)** 10% early withdrawal payout penalty if the taxpayer has *not* yet reached age 59½ (and, one of the exceptions does *not* otherwise applied). As shown by this private letter ruling, the IRS can be very reluctant in waiving (or, extending) the 60-day period. In this instance, it refused to grant additional time to an individual who used some of his IRA balance to help make a cash offer on the purchase of a new home. He had intended to replace the funds in his IRA with the proceeds from the sale of his current residence, but that property failed to sell until more than 60 days after the IRA withdrawal. **(Code §408; IRA Withdrawals)**

> **Comment:** While **Code §408(d)(3)(I)** does grant the IRS the authority to waive a late rollover "where the failure to waive such requirement would be against equity or good conscience," the Service has stated clearly that returning a "loan" late will *not* meet that criteria. While the "borrowing" noted above is permitted since nothing in the IRC bars it, that was *not* the purpose of the rollover provision. Instead, that provision was meant to allow taxpayers to move funds from one account to another and, at least according to the IRS, it is *not* against "equity or good conscience" to deny relief when a taxpayer was using the provision for other purposes.

> **Comment:** Unlike a 401(k) or 403(b) qualified retirement plan, the Code does *not* impose a requirement on an IRA custodian to inform individuals of the 60-day rollover rule, and the failure

of a financial institution to provide this information (as was the situation in this case) does *not* rise to the level of “financial institution error.”

☞**Self-Certification Procedure for Late Retirement Plan Rollovers (Rev. Proc. 2016-47)**
The IRS has provided a new “self-certification procedure” designed to help recipients of retirement plan distributions who, due to one or more specified reasons, inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or IRA. The new self-certification procedure allows these taxpayers to claim eligibility for a waiver of the 60-day rollover requirement that can be relied upon by a plan administrator or IRA trustee in accepting and reporting receipt of the rollover contribution.

Comment: **Rev. Proc. 2020-46** modifies and updates **Rev. Proc. 2016-47**, which provides a list of permissible reasons for a taxpayer to self-certify eligibility for a waiver of the 60-day rollover requirement under certain eligible retirement plans. This Revenue Procedure *modifies* that list by adding a new reason: a distribution was made to a state unclaimed property fund.

New Self-Certification Option: A taxpayer may make a written certification to a plan administrator or an IRA trustee, custodian, or issuer by using the “model letter” provided in **Rev. Proc. 2016-47** (or, by using a letter that is substantially similar in all material respects). A copy of the certification should be kept in the taxpayer's files and be available if requested on audit. The certification must state that a contribution satisfies the following conditions:

- The IRS must *not* have previously denied a waiver request with respect to a rollover of all or part of the distribution to which the contribution relates;

- The taxpayer must have missed the 60-day deadline because of the taxpayer's inability to complete a rollover due to one or more reasons set out in **Rev. Proc. 2016-47, §3.02(2)**, including error by the financial institution, postal error, and a death in the taxpayer's family;

- The contribution must be made to the plan or IRA “as soon as practicable after the applicable reason(s) no longer prevent the taxpayer from making the contribution.” This requirement is deemed to be satisfied if the contribution is made within 30 days after that time.

The IRS intends to modify the instructions to **Form 5498, IRA Contribution Information**, to require that an IRA trustee that accepts a rollover contribution *after* the 60-day deadline report that the contribution under those circumstances. (**Rev. Proc. 2016-47, §3.03**)

A plan administrator or IRA trustee may, absent actual knowledge to the contrary, rely on a taxpayer's self-certification solely for purposes of determining whether the taxpayer has satisfied the conditions for a waiver of the 60-day rollover requirement. (**Rev. Proc. 2016-47, §3.04(1)**)

The IRS cautioned that this self-certification process is *not* technically a waiver of the 60-day requirement. Nevertheless, a taxpayer may report the contribution as a valid rollover unless later informed otherwise by the IRS. But, if IRS in the course of an examination determines that the requirements for a waiver were *not* actually met, the taxpayer may be subject to additions to income and penalties, such as the penalty for failure to pay the proper amount of tax under **Code §6651**. (**Rev. Proc. 2016-47, §3.04(2)**)

The modification of **Rev. Proc. 2016-47** also *modifies* **Rev. Proc. 2003-16**, by providing that, in addition to automatic waivers and those granted via application for a letter ruling, the IRS may grant a waiver during an examination of the taxpayer's income tax return. (**Rev. Proc. 2016-47, §4**)

Effective Date: **Rev. Proc. 2016-47** is effective on Aug. 24, 2016. (**Rev. Proc. 2016-47, §5**) (**Code §408**; **IRA Rollovers)**

☞**IRA Trustee-to-Trustee Transfers Not Counted for One-per-Year Limit on Rollovers (Info. Ltr. 2015-0035)**

The IRS has confirmed that trustee-to-trustee transfers avoid the one-rollover-every-12-months rule. Taxpayers with multiple IRAs have a limit of one rollover every 12 months which applies on an aggregate basis to all of the IRAs, and *not* on an IRA-by-IRA basis. As a result, someone who takes a distribution from their IRA and timely rolls the money back (i.e., within 60 days) is *not* permitted to withdraw funds from any other IRA during the following 12 months and do another tax-free rollover. Nevertheless, IRA owners can continue to make unlimited trustee-to-trustee transfers between IRAs because such direct transfers of IRA funds are *not* considered to be "rollovers." Also, the IRA owner can be given a check payable to the new IRA for their benefit. **(Code §408; IRA)**

Code §408A - Roth IRAs:

☞**Surviving Spouse Allowed Rollover of Roth IRA (PLR 202136004)**

A surviving spouse requested a ruling on the proposed rollover of a Roth IRA distribution into one or more Roth IRAs in her sole name after the death of her spouse. At the time of his death, the decedent maintained a Roth IRA with a trust as the sole beneficiary and the surviving spouse was the sole beneficiary of that trust. The IRS determined that the surviving spouse is eligible to roll over the Roth IRA distribution into one or more Roth IRAs established and maintained in her own name. Provided that the rollover is timely, the surviving spouse will *not* be required to include the distribution in gross income for federal income tax purposes. Also, in the year following the year of the rollover the surviving spouse will *not* be required to take required minimum distributions from her Roth IRA during her lifetime. **(Code §408A; Roth IRAs)**

Code §414 - Definitions and Special Rules:

☞**Workers' Prior Service Counted for Retirement Plan Eligibility and Vesting Purposes (CCA 202019018)**

The IRS has determined that leased workers' period of service that occurred before they were hired as regular employees should be taken into account when calculating years of service for purposes of retirement plan eligibility and vesting. Pursuant to **Code §414(n)(4)(B)**, the four-month period of work under a leasing arrangement must be counted for purposes of minimum participation and vesting under the qualified retirement plan of a company that used a staffing agency to hire workers through a leasing arrangement who ultimately became full-time employees, despite the fact that now-common law employees never satisfied requirements to be leased employees. **(Code §414; Retirement Plans)**

Code §3405 - Special Rules for Pensions, Annuities, and Certain Other Deferred Income:

☞**Final Regs Released on Income Tax Withholding on Certain Periodic Retirement and Annuity Payments (IR-2020-223)**

The IRS has issued final regulations (**TD 9920**) updating the federal income tax withholding rules for certain periodic retirement and annuity payments made *after* 12/31/20. The regulations specify that the IRS will provide the rules and procedures for determining the default withholding rate on periodic payments in applicable forms, instructions, publications, and other guidance. In July 2020, the IRS released a draft of a redesigned **Form W-4P (Withholding Certificate for Pension or Annuity**

Payments) for 2021. However, based on comments from stakeholders, the IRS has decided to postpone issuance of the redesigned form. Instead, the 2021 **Form W-4P** "will be similar to the 2020 version." The IRS also intends to provide in the instructions to the 2021 **Form W-4P** that the default withholding rate will continue to be determined by treating the taxpayer as a married individual claiming three withholding allowances. **(Code §3405; Withholding Tax)**

Code §4975 - Tax on Prohibited Transactions:

☞**Prohibited Transactions Caused Loss of Bankruptcy Protection for IRA (*Yerian*, No. 18-10944 (6/26/2019))**

Because the taxpayer engaged in some **prohibited transactions**, the normal protection from third-party creditors with regard to IRA fund was lost. The taxpayer, in anticipation of filing bankruptcy, purchased a condo and two cars with their IRA funds. As a result, this protection was lost and creditors were allowed to attached the retirement plan funds. **(Code §4975; Prohibited Transactions)**

☞**Previous Prohibited Transactions Distributions Retroactively Disqualified IRA (*Marks*, TC Memo 2018-49 (11th Cir., 4/10/2018))**

A distribution received by a taxpayer from an account that was no longer treated as a taxable IRA was nontaxable because the account had engaged in a "prohibited transaction" years before and, as a result, the account was no longer an IRA. More importantly, the statute of limitations had passed with regard to the disqualification of the IRA.

> **Comment:** Since the account was no longer an IRA, and because the statute of limitations had run, the the taxpayer did *not* have to include $98,000 in distributions of two promissory notes ($40,000 on a loan to her father and $60,000 on a loan to her friend were the "prohibited transactions" made previously) from this former IRA in her gross income. In addition, she was *not* liable for the **Code §72(t)** 10% early withdrawal penalty, or the **Code §6662** penalty for failure to pay tax. **(Code §4975; Prohibited Transactions)**

Code §6502 - IRS Assessments:

☞**Being Forced to Tap Retirement Assets to Satisfy Back Taxes (*Lowery*, TC Memo. 2019-151 (11/18/2019))**

A couple who owed $640,000 in back taxes offered to pay $6,341 a month pursuant to a six-year installment plan. The Service countered that they were capable of paying much more, but agreed to the offer if the couple also liquidated and paid over a retirement account belonging to the 60-year-old husband. The couple objected, claiming that he was "too close to retirement, and liquidating the account would be a hardship." The Tax Court remanded the case back to IRS's appeals office to examine whether circumstances such as the husband's age should restrict tapping the account to pay the outstanding taxes. **(Code §6502; IRS Assessments)**

Code §6751 - IRS Penalties:

☞**Sec. 72(t) 10% Early Distribution Amount Is Tax, Not Penalty (*Grajales*, 156 TC No 3 (1/25/2021))**

The Tax Court has concluded that the **Code §72(t)(1)** 10% early distribution exaction is a tax, *not* a penalty. As a result, the **Code §6751(b)** requirement for written supervisory approval of penalties does *not* apply to it.

Background: Code §6751(b) provides that no penalty under the Code can be assessed unless the initial determination of such assessment "is personally approved (i.e., in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate."

Meanwhile, the term "penalty" includes any addition to tax or any additional amount. (**Code §6751(c)**) **Code §72(t)(1)**, which is labeled as a "10-percent additional tax on early distributions from qualified retirement plans" and sub-captioned "Imposition of additional tax," provides that "[i]f any taxpayer receives any amount from a qualified retirement plan (as defined in **Code §4974(c)**), the taxpayer's tax" shall be increased by 10% (unless an exception applies).

Tax Court Decision: In this instance, a taxpayer took an early distribution from her IRA. No exceptions applied, and the IRS determined that the **Code §72(t)(1)** 10% penalty tax applied. The taxpayer argued that the 10% exaction was a "penalty" and that therefore the IRS needed to comply with **Code §6751(b)** *before* assessing it. But the Tax Court held that the **Code §72(t)(1)** 10% exaction is a "tax," *not* a penalty, addition to tax or, an additional amount. Therefore, it is *not* subject to the written supervisory approval requirement of **Code §6751(b)**. **(Code §6751; IRS Penalties)**

RETIREMENT PLANS & FRINGE BENEFITS - CONSULTING ISSUES:

Code §401 - IRA/Pension Plans - Required Minimum Distributions:

☞**Understanding the Rules for Tax-free Roth IRA Distributions**
It is very important to understand the "five-year rule" on Roth IRA contributions and payouts since it will dictate whether payouts of Roth IRA earnings are tax-free or not. Normally, distributions of earnings from Roth IRAs are tax-free if the owner is at least 59½ at the time of the withdrawal **and** at least five tax years have passed since the owner first made a contribution into any Roth IRA. In other words, the five-year waiting period starts the first time money is deposited into *any* Roth IRA that an individual might owned, through either a contribution or a conversion from a traditional IRA. As a result, this waiting period does *not* restart for subsequent Roth pay-ins or for newly-opened Roth IRA accounts. For example, supposed an individual owned a Roth since 2010, and then in Jan. 2021, they opened and funded a *second* Roth IRA. Because first Roth IRA was funded in 2010, there is no need to wait five years to take money from that second Roth IRA for the earnings to be tax-free, so long as the individual is at least 59½ at the time of the payout. It should be noted that it is only the Roth *earnings* in the account that this five-year waiting period applies to. The ability to get at the principal balance (i.e., what has been contributed in after-tax dollars) can be accessed at any time. **(Code §408A; Roth IRAs)**

☞**Utilizing Net Unrealized Appreciation Strategy to Save Taxes**
This planning approach is for employees who have purchased stock of their employers through their 401(k) workplace retirement accounts over the years, and that stock has now significantly appreciated. One of the key requirements is that you are age 59½ or older when you retire. If so, you have the option to take a lump sum distribution of the stock and put it in a taxable investment account, while transferring the remaining 401(k) assets, such as cash and other investments, into your IRA. There are two tax consequences associated with this net unrealized appreciation (NUA) strategy. First of all, you are required to pay tax at *ordinary* income tax rates on the cost basis (i.e., as opposed to their current FMV) of these employer shares in the year of the distribution. But, when you eventually sell the shares, the net unrealized appreciation is treated as long-term capital gain. The NUA amount is the difference between fair market value and cost basis of these shares as of the date of distribution from the 401(k) plan. In other words, if you hold the stock more than a year before selling it, then any post-distribution gain will

also be taxed as LTCGs. On the other hand, if you only hold the stock for a year or less before selling it, then post-distribution gain is taxed as short-term capital gain (i.e., at ordinary rates).

Example: An employee has purchased stock of their employer using pre-tax funds in her 401(k) account. The original cost of these shares was $50,000. But, at the time of their retirement, the shares had a current fair market value of $200,000. The employee decides to retire at age 62, at which time they transfer any non-employer-stock assets, securities and cash into an IRA, while taking a taxable payout of her employer stock and puts it into a separate brokerage account. For the year of the 401(k) distribution, they will owe tax at ordinary income tax rates on the $50,000 stock basis. Assume, however, that they sell the stock four years later for $275,000. The $150,000 net unrealized appreciation and the $75,000 post-distribution gain will both be taxed at long-term capital gains rates, resulting in a significant tax savings.

By way of comparison, suppose that this employee upon retirement transferred the shares of their employer stock directly into an IRA. There would be a delay on the immediate taxation of this transferred amount, but when the stock is eventually distributed to this retiree from their IRA, they would pay tax at ordinary rates on the *entire* value of those shares, including the appreciation built up in the 401(k) (which could be as much as $275,000 four years after retirement).

There are a number of factors which should be considered when deciding to use this "NUA strategy." This includes the following factors:

1. It makes the most sense when the stock has substantially appreciated while being held in the employee's 401(k) plan. In other words, the lower the cost basis in the shares, the more tax-advantageous the strategy.

2. The projected difference between the retiree's tax rates on ordinary income and capital gains is an important factor. The greater the differential between the rates, the more attractive the strategy will be.

3. The liquidity of the employee's retirement assets, their "time horizon," risk tolerance level and whether they eventually plan to donate some or all of the distributed stock to charity. **((Code §401; NUA)**

☞When Is Withholding Required for Retirement Plan Distributions?

Distributions from an employer-sponsored retirement plan may or may not be subject to withholding depending on the nature of the payment. In some cases, withholding is mandatory, and in others the recipient can elect out.

Comment: The IRS's **Retirement News for Employers** provides an excellent summary of the current rules for both payors and payees.

Withholding on Eligible Rollover Distributions: In general, the payor of any "designated distribution" that is an "eligible rollover distribution" must withhold an amount equal to 20% of the distribution. A "designated distribution" is a distribution or payment from, or under: (1) an employer deferred compensation plan, (2) an IRA or individual retirement annuity; or (3) a commercial annuity. An "eligible rollover distribution" generally is a plan distribution from an "eligible retirement plan" (i.e., plan distributions other than periodic distributions, minimum required distributions, or hardship distributions). (**Code §3405**) Most importantly, the recipient of a distribution that is otherwise subject to 20% withholding is *not* permitted to elect out of the withholding requirement. (**Reg. §31.3405(c)-1**) However, "eligible rollover distributions" are *not* subject to withholding if expected distributions to an individual are *less than* $200 for the year. Also, 20% withholding generally only applies to any previously untaxed amount of an eligible rollover distribution. Nevertheless, the most important exception is that no withholding is required if the plan *directly rolls over* (i.e., in a trustee-to-trustee transfer) the eligible rollover distribution amount to another qualified retirement plan or IRA.

Periodic Payments: The payor of a "periodic payment" (i.e., one made at regular intervals for more than one year, such as an annuity) that is *not* an "eligible rollover distribution" must withhold from the payment as if it were a wage payment for the appropriate payroll period. (**Code §3405(a)(1)**) In this regard, the plan administrator is required to withhold at the rate for a married individual with 3 withholding exemptions. However, recipients have the right (and must be so informed by the plan administrator) to: (1) elect no withholding or elect to have a different amount withheld, by filing **Form W-4P, Withholding Certificate for Pension or Annuity Payments**, with the plan administrator; and (2) revoke the election at any time.

Nonperiodic Payments: A "nonperiodic payment" is a distribution that usually is *not* made at regular intervals and is *not* an "eligible rollover distribution." Examples of nonperiodic payments would include:

- distributions of excess annual additions;

- distributions of excess contributions and excess aggregate contributions from most plans if made within 2½ months after the end of the plan year;

- hardship distributions; and

- loans treated as distributions.

Nonperiodic Payments Generally Subject to 10% Withholding: As stated above, despite normally being subject to withholding, the recipient may nevertheless elect to have no withholding, or have a different amount withheld by filing a Form W-4P with the plan administrator.

Special Situations: Plan administrators need to be aware that special rules apply to:

- distributions made because of recognized disasters;

- distributions delivered outside the U.S. or U.S. possessions;

- certain noncash distributions, including employer securities; and

- a participant's accrued benefit offset because of a defaulted loan.

Designated Roth Accounts: For distributions from designated Roth accounts in 401(k), 403(b), or 457(b) plans, payors and payees should be reminded that there is no withholding required for a qualified distribution from a designated Roth account because the distribution is *not* otherwise taxable. If a nonqualified distribution is made from such an account, withholding is required only from any distributed earnings that the recipient must include in gross income. **(Code §401; Pension Plan Distributions)**

☞**Calculating Earned Income for Self-employed Individuals with Qualified Retirement Plans**
The IRS has offered guidance on how to calculate "compensation" for plan purposes for sole proprietors who maintain qualified retirement plans under **Code §401** and SEP IRA plans under **Code §408(k)**.

Compensation v. Earned Income: "Compensation" is remuneration for an employee's personal services received in the course of employment with an employer. "Earned income" is income attributable to an individual's personal services in conducting a trade or business. For self-employed individuals (SEIs), who are usually sole proprietors or partners, "earned income" must be used in place of "compensation" when computing the limits on deductible contributions under **Code §404(a)(3)**. Earned income instead of compensation is also used to apply rules in the following areas for plans covering SEIs: allocations; accruals; deductions; nondiscrimination; and benefit and contribution limits.

Calculating an SEI's Earned Income for Plan Purposes: If non-elective contributions made on behalf of an SEI to a defined contribution plan are determined as a percentage of the SEI's earned income, then the earned income calculation is dependent on the SEI's contribution; but the SEI's contribution is also dependent on the amount of earned income. If the SEI did *not* make any elective deferrals and the contribution made on the SEI's behalf is fully deductible, then earned income is calculated as follows:

Earned income (EI) = NESE - 164(f) deduction - SEI's contribution deduction

The SEI's contribution deduction is calculated as follows:

Contribution deduction = EI x Plan Rate

According to this **"Issue Snapshot,"** the contribution formula is "algebraically restructured" to remove the unknown "EI" variable and replace it with known quantities as follows:

SEI Contribution Deduction = (NESE - 164(f) deduction) x (Plan Rate / (1 + Plan Rate))

Once the SEI's contribution is known, EI is easily calculated. To check for accuracy, multiplying EI by the plan rate should result in the same contribution amount. **(Misc.; Retirement Plans)**

☞**Increase Withholding on Retirement Plan & IRA RMDs v. Paying Estimated Taxes**
Since withheld taxes are treated as having been paid evenly throughout the tax year (even if paid only at yearend), a planning strategy might be to deliberately over-withhold these taxes. Retirees are able to instruct brokerage firms and custodians on IRA accounts to withhold whatever percentage for federal and state income taxes as the account owners direct. It is basically no different than when you might have had your paychecks toward the end of the year hold back a substantial amount in income tax (i.e., some owner/employees basically set up a "zero sum paycheck" and have the entire amount go to federal and state income taxes after employment taxes are first set aside. **(Misc.; Tax Withholding)**

Comment: With the Charles Swab brokerage firm, for instance, they allowed you to set whatever percentage you desire when distributing monies out of either a Solo 401(k) or a traditional IRA. You can instruct them, based on your projected effective tax rate, to withhold 20% for federal income tax purposes and 5% for state taxes and they will forward these amounts on your behalf to the IRS and state department of revenue.

Code §408 - IRAs:

☞**How to Tap IRAs Penalty-Free for Educational Expenses**
Accessing an IRA before age 59½ to pay higher education costs can be penalty-free, if you do it correctly. Expenses covered under this exception include college tuition, textbooks, supplies, and the cost of room and board for students enrolled at least half-time. But to qualify, the payout must cover education costs and be paid in the *same* year that the withdrawal from the IRA actually occurs (and, for which the

IRS will be receiving a "paper trail" via a **Form 1099-R**). Payouts can be used to pay expenses for the IRA owner, spouse, child or grandchild. Of course, even if the distribution is exempt from the 10% early withdrawal penalty, income tax will nevertheless be due (i.e., since such withdrawals must be included in the account owner's gross income).

> **Comment:** Remember that, conversely, early payouts from 401(k)s to fund education do *not* receive penalty-free treatment. Furthermore, the IRS has an excellent **website** that summarizes these rules.

Notes:

EMPLOYMENT TAXES:

Miscellaneous:

☞**IRS Orders Immediate Stop to Processing New Employee Retention Credit Claims (IR-2023-169)**
This "moratorium" on processing of new claims through year's end "will allow IRS to add more safeguards to prevent future abuse, protect businesses from predatory tactics." In the meantime, the IRS is working with the Justice Department to pursue fraud fueled by aggressive marketing tactics.

IRS Commissioner Danny Werfel ordered the immediate moratorium, beginning 9/14/23, to run through at least Dec. 31st following growing concerns inside the tax agency, from tax professionals as well as media reports that "a substantial share of new claims from the aging program are ineligible and increasingly putting businesses at financial risk by being pressured and scammed by aggressive promoters and marketing."

The IRS will continue to process previously-filed Employee Retention Credit (ERC) claims received prior to the moratorium but renewed a reminder that increased fraud concerns means processing times will be longer. On July 26, the agency announced it was increasingly shifting its focus to review these claims for compliance concerns, including intensifying audit work and criminal investigations on promoters and businesses filing dubious claims. The IRS announced today that hundreds of criminal cases are being worked, and thousands of ERC claims have been referred for audit.

The IRS emphasizes that payouts for these claims will continue during the moratorium period but at a slower pace due to the detailed compliance reviews. With the stricter compliance reviews in place during this period, existing ERC claims will go from a standard processing goal of 90 days to 180 days - and much longer if the claim faces further review or audit. The IRS may also seek additional documentation from the taxpayer to ensure it is a legitimate claim.

This enhanced compliance review of existing claims submitted before the moratorium is critical to protect against fraud but also to protect the businesses from facing penalties or interest payments stemming from bad claims pushed by promoters.

"The IRS is increasingly alarmed about honest small business owners being scammed by unscrupulous actors, and we could no longer tolerate growing evidence of questionable claims pouring in," Werfel said. "The further we get from the pandemic, the further we see the good intentions of this important program abused. The continued aggressive marketing of these schemes is harming well-meaning businesses and delaying the payment of legitimate claims, which makes it harder to run the rest of the tax system. This harms all taxpayers, not just ERC applicants."

"For those people being pressured by promoters to apply for the Employee Retention Credit, I urge them to immediately pause and review their situation while we look to add new protections and safeguards to stop bad claims from ever coming in," Werfel said. "In the meantime, businesses should seek out a **trusted tax professional** who actually understands the complex ERC rules, not a promoter or marketer hustling to get a hefty contingency fee. Businesses that receive ERC payments improperly face the daunting prospect of paying those back, so we urge the utmost caution. The moratorium will help protect taxpayers by adding a new safety net onto this program to focus on fraudulent claims and scammers taking advantage of honest taxpayers."

Taxpayers are encouraged to review IRS guidance and tools for helping determine **ERC eligibility**, including **frequently asked questions** and a new question and answer **guide** to help businesses understand if they are actually eligible for the credit.

The IRS is developing new initiatives to help businesses who found themselves victims of aggressive promoters. This includes a settlement program for repayments for those who received an improper ERC payment. More details on this settlement program will be available later this fall.

In addition, the IRS is finalizing details that will be available soon for a "special withdrawal option" for those who have filed an ERC claim but the claim has *not* yet been processed. This option will allow the taxpayers, many of them small businesses who were misled by promoters, to avoid possible repayment issues and paying promoters contingency fees. Filers of these more than 600,000 claims awaiting processing will have this option available. But those businesses that have "willfully filed fraudulent claims or conspired to do so" should be aware, however, that withdrawing a fraudulent claim will *not* exempt them from potential criminal investigation and prosecution.

As part of the wider compliance effort, the IRS is working with the Justice Department to address fraud in the ERC program as well as those promoters who have been ignoring the rules and pushing businesses to apply.

The IRS has trained auditors examining ERC claims "posing the greatest risk," and the IRS Criminal Investigation division is actively working to identify fraud and promoters of fraudulent claims for potential referral for prosecution to the Justice Department.

As of July 31, 2023, IRS-CI has initiated 252 investigations involving over $2.8 billion of potentially fraudulent Employee Retention Credit claims. Of those, fifteen of the 252 investigations have resulted in federal charges. Of the 15 federally charged cases, so far six matters have resulted in convictions, four of those cases have reached the sentencing phase with the average sentence being 21 months. Criminal Investigation's work is in addition to ERC audits that have started. And the IRS has already referred thousands of ERC cases for audit.

The IRS reminds anyone who improperly claims the ERC that they must pay it back, possibly with penalties and interest. A business or tax-exempt group could find itself in a much worse financial position if it has to pay back the credit than if the credit was never claimed in the first place. This underscores the importance of taxpayers taking precautionary steps to independently verify their eligibility to receive the credit before applying through a promoter. Taxpayers should take particular precautions because a promoter can collect a contingency fee of up to 25% of the ERC refund.

For those currently with a pending application at the IRS, they should review the options below to see if any of those could help with their current situation.

- For those who have *not* filed a claim yet, consider reviewing the guidelines and waiting to file: For those considering filing a claim, the IRS urges businesses to carefully review the ERC guidelines during the processing moratorium period. The IRS urges businesses to talk to a trusted tax professional (*not* a tax promoter or marketing firm looking to make money generating applications that takes a big chunk out of the ERC claim). The new question and answer **guide** can also help. A careful review of the rules will show that many of these businesses do *not* qualify for the ERC, and avoiding a bad claim will avoid complications with the IRS.

- Withdraw an existing claim for businesses that have already filed: For those who have filed and have a pending claim, they should carefully review the program guidelines with a trusted tax professional and check the new question and answer guide. For example, the IRS is seeing repeated instances of people improperly citing "supply chain issues" as a basis for an ERC claim when a business with those issues will very rarely meet the eligibility criteria. Under any scenario, if a business claimed the ERC earlier and the claim has *not* been processed or paid by the IRS, they can withdraw the claim if they now believe it was submitted improperly - even if their case is already under audit or awaiting audit. The IRS stated that "more details will be available shortly."

- **Wait for the IRS ERC settlement program to be finalized:** As stated above, if a business has already received an ERC that they now believe is in error, the IRS will be providing additional details on the settlement program in the fall that will allow businesses to repay ERC claims. The settlement program will allow the businesses to avoid penalties and future compliance action. The IRS is continuing to assess options on how to deal with businesses that had a promoter contingency fee paid for out of the ERC payment. **(Code §3401; ERC)**

☞IRS Outlines Procedure for Withdrawal of ERC Claims (IR 2023-193)

As part of a larger effort "to protect small businesses and organizations from scams," the Service has announced the details of a "special withdrawal process" to help those who filed an Employee Retention Credit (ERC) claim and are now concerned about its accuracy. This new withdrawal option allows certain employers that filed an ERC claim but have *not* yet received a refund to withdraw their submission and thereby avoid future repayment, interest and penalties. As a result, employers that submitted an ERC claim that is still being processed can withdraw their claim and avoid the possibility of getting a refund for which they are ineligible.

> **Comment:** The IRS created this "withdrawal option" to help small business owners and others "who were pressured or misled by ERC marketers or promoters into filing ineligible claims." Claims that are withdrawn will be treated as if they were never filed. Thus, the IRS will *not* impose any penalties or interest.

Taxpayers can use this "ERC claim withdrawal" if *all* of the following apply: 1) They made the claim on an adjusted employment return (i.e., **Form 941X**); 2) They filed the amended payroll tax return only to claim the ERC and made no other adjustments; 3) They want to withdraw the *entire* amount of their ERC claim; and 4) The IRS has *not* yet paid their claim, or the IRS has paid the claim, but the taxpayer has *not* cashed or deposited the refund check. **(Code §3401; ERC)**

> **Comment:** Specific detailed instructions for withdrawing an ERC claim can be found on the IRS **website**.

> **Comment:** As clients continued to get bombarded with potential ERC refund claims, especially by third-parties who want to be compensated by receiving a percentage of the potential refund, we need to stand our ground that, in most cases, the possibility of qualifying for an ERC refund has been thoroughly examined previously. And, in the appropriate cases where the client did qualify, **Form 941X** has already been filed. If the client is instead pressuring us to now file for the ERC despite our earlier efforts and based on faulty information, remember that the **IRS Office of Professional Responsibility** and **Circular 230** bar us from signing off on a return (including amended ones) that have no merit.

> **Comment:** In order to avoid preparer penalties, we must have "substantial authority" to support the position that we are taking on a client's return. One of the areas that has been somewhat controversial concerns whether the wages of an owner/employee of an S corporation count as "qualified wages" for purposes of the employer retention credit. At first, the FAQs in this area indicated that they did. Then, on Aug. 4, 2021 the IRS came out with guidance that employed a convoluted "double attribution rule" that maintain that only "orphans" with no living family members would have wages that would qualify. This is in spite of the fact the nothing of the sort was ever mentioned by Congress when they passed the ERC provision as part of their "legislative intent."

Comment: The other controversy concerns the need to file amended returns even where the ERC amount is received in a subsequent tax year. Here, Congress specifically addressed this issue in **Notice 2021-49** and insists that amended returns that reduce the amount of "qualified wages" originally claimed need to be filed. This applies even where the taxpayer was on the cash method of accounting and despite the normal availability of the "tax benefit rule" pursuant to **Code §111**.

☞**New FAQs on the Employee Retention Credit**

As part of its on-going efforts to combat Employee Retention Credit (ERC) schemes, the IRS has released a new list of **Frequently Asked Questions (FAQs)**. These FAQs provide general guidance on key areas of the ERC including eligibility, claiming the credit, ERC scams, recordkeeping, and more. Taxpayers who did *not* claim the ERC on their original returns may file an amended **Form 941-X** **(Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund)**. The deadline for claiming the ERC is typically 4/15/24, for 2020 tax periods, and 4/15/25, for 2021 tax periods. Taxpayers who improperly claim the ERC must repay the credit plus possible penalties and interest. The IRS warns against aggressive ERC promoters who claim that all businesses are eligible for the credit and reminds taxpayers that specific requirements must be met in order to qualify for the credit.

Comment: Despite the indication in the original FAQs outstanding in the spring of 2021, the IRS continues to maintain that the "legislative intent" when Congress passed this relief provision is that the wages of an majority owner/employee of an S corporation (and, also those other employees who would be considered majority owner under the attribution rules) would *not* be treated as "qualified wages." The only exception, which is hard to comprehend, is where that owner is an "orphan" with no living parents, children, siblings so that this convoluted "attribution rule" would *not* come into play. This "clarification" came out on the afternoon of 8/4/21 long after ERC claims were filed for the first two quarters of 2021 (let alone "advanced ERC" applications on **Form 7200**).

Additional FAQs: The following additional FAQs were added on July 28, 2023:

- **Qualifying government orders:** The FAQs explain that one of the qualifications for the ERC is that a business must have been "subject to a government full or partial shutdown order" as a result of the pandemic and the business did *not* operate as a result of the order. This can be a federal, state, or local order. The FAQs now provide a number of examples. For instance, it clarifies that a mere "recommendation from the government" is *not* sufficient to satisfy the requirement. Furthermore, if a business "was able to sustain operations by using remote workers during a shutdown order," the business would *not* qualify for the ERC. The FAQs also note that "supply chain issues" alone will *not* qualify a business for the ERC and provide a reference to a recent legal memo.

Comment: The FAQs now also contains a *new* warning that taxpayer should *not* accept a "generic document" about a government order from a third party. If a third party claims ERC eligibility, taxpayers should request a copy of the *actual* government order. In addition, the order should be reviewed to determine if the order applied to the taxpayer's business.

- **Decline in gross receipts:** The other "ERC qualifying reason" would be a "significant decline" in gross receipts during 2020 or a decline in gross receipts during the first three quarters of 2021. Here again, the FAQs provide a number of examples.

- **Recovery startup business:** The FAQs provide the special conditions under which a "recovery startup business" may qualify for the ERC for the third and fourth quarters of 2021. These businesses, however, are *not* permitted to use the "government order or decline in gross receipts tests" in order to qualify for a potential ERC.

- Timing: The FAQs note that the IRS is still processing ERC claims. The **IRS Operations: Status of Mission-Critical Functions** webpage provides updates on the backlog of **Forms 941** and **941-X** processing. As of July 27, 2023, the IRS had 735,000 unprocessed **Forms 941**. As of July 26, 2023, the IRS had 506,000 unprocessed **Forms 941-X**. **(Code §3134; ERC)**

> **Comment:** The IRS is considering "legislative solutions" to stem the ERC fraud and potential errors. A possible suggestion would to put "an earlier end date for claiming the credit." Generally, for 2020 tax periods, the deadline is April 15, 2024. For 2021 tax periods, the deadline is April 15, 2025.

☞Social Security Wage Base Increases to $168,600 for 2024

The Social Security Administration has announced that the maximum earnings subject to the Social Security component of the FICA tax will increase from $160,200 to $168,600. For 2023, the maximum Social Security tax that employers and employees will each pay is $10,453 (i.e., $168,600 x 6.2%). Also, based on the increase in inflation measured in the Consumer Price Index (CPI-W) from the third quarter of 2022 through the third quarter of 2023, Social Security and Supplemental Security Income (SSI) recipients will receive a 3.2% cost of living adjustment (COLA) for 2024. This COLA adjustment will take effect at the end of 2023 or January 2024 for the roughly 71 million recipients. **(Code §3401; FICA)**

> **Comment:** And, of course, this is in addition to the 1.45% Medicare rate which applies to all wages or 2.9% rate on self-employment income. Bottom line is that 15.3% (ER: 7.65% and EE: 7.65% = $25,795.80).

> **Comment:** The Medicare surtaxes (i.e., as shown on **Form 8959** and **Form 8960**) will remain at .9% and 3.8%, respectively. Meanwhile, the $200,000/250,000 thresholds have never been indexed for inflation since they were first introduced into the law in 2013.

☞Social Security Wage Base Soaring to $160,200 for 2023 (SSA Release 10/13/22)

The Social Security Administration (SSA) recently announced that the maximum earnings subject to the Social Security component of the FICA tax will increase from $147,000 to $160,200 for 2023. As a result, the maximum Social Security tax that employers and employees will each pay in 2023 will be $9,932.40 ($160,200 x 6.2%). Meanwhile, the Medicare component remains on 1.45% of all earned income, In addition, individuals with earned income of more than $200,000 ($250,000 for married couples filing jointly, $125,000 for married filing separately) will pay an additional 0.9% in Medicare taxes. And based on the increase in the Consumer Price Index (CPI-W) from the third quarter of 2021 through the third quarter of 2022, approximately 70 million Social Security and Supplemental Security Income (SSI) beneficiaries will receive a 8.7% cost-of-living adjustment (COLA) for 2023.

> **Comment:** Other 2023 COLAs announced by the SSA are available on their **website**.

> **Comment:** The **Code §1411** 3.8% and .9% Medicare surtaxes (i.e., as shown on **Form 8960** and **Form 8959** respectively) have *not* been indexed for inflation since they were first introduced into the tax law for the 2014 tax year.

☞New 2023 Tax Year Electronic Filing Requirement for W-2 and Information Forms

The IRS has released changes to **Form W-2** and **Form W-2c** that highlight the updated electronic filing mandate for these forms. **Reg. §301.6011-2** was amended by **TD 9972** which lowers the threshold to 10 for which employers must file certain information returns electronically including **Form W-2**, **Form W-2AS**, **Form W-2GU**, **Form W-2VI**, and **Form 499R-2/W-2PR**. **Form W-2c** can only be filed electronically if the original **Form W-2** was required to be filed electronically. To determine whether they must file information returns electronically, employers are required to aggregate the number of information returns and the number of **Forms W-2** they must file in a calendar year. Information returns include **Form 1042-S**, the **Form 1094** series, **Form 1095-B**, **Form 1095-C**, **Form 1097-BTC**, **Form 1098**, **Form 1098-C**, **Form 109-E**, **Form 109-Q**, **Form 1098-T**, the **Form 1099** series, **Form 3921**, **Form 3922**, the **Form 5498** series, **Form 8027**, and **Form W-2G**. **(Misc.; Information Returns)**

> **Comment:** These new electronic filing rules apply to any of the forms required to be filed for the 2023 tax year.

☞**IRS Notices CP2100 and 2100A for Filing Incorrect Information Return** (**Tax Tip 2023-75**)

When banks, credit unions, businesses and other payers file information returns with data that does *not* match IRS records, the IRS sends them a **CP2100 or CP2100A notice**. The notices tell these payers that the information returns they submitted have a missing or incorrect Taxpayer Identification Number (TIN), name or both. Each notice has a list of payees with the issues the IRS found. Payers need to compare the accounts on the notice with their account records and correct or update their records, if necessary. Payees may also need to correct their backup withholding on payments made to payees.

The IRS sends **CP2100** and **CP2100A** notices twice a year in September and October and again in April with regard to those information returns that may contain incorrect information. The IRS sends notices for errors most frequently found on these forms:

- Form 1099-B, Proceeds from Broker and Barter Exchange Transactions
- Form 1099-DIV, Dividends and Distributions
- Form 1099-G, Certain Government Payments
- Form 1099-INT, Interest Income
- Form 1099-K, Payment Card and Third Party Network Transactions
- Form 1099-MISC, Miscellaneous Information
- Form 1099-NEC, Non-employee Compensation
- Form 1099-OID, Original Issue Discount
- Form 1099-PATR, Taxable Distributions Received from Cooperatives
- Form W-2G, Certain Gambling Winnings

If the payments involved are subject to **back-up withholding**, **CP2100** and **CP2100A** notices also tell payers that they may be required to back-up withhold tax payments. If the payments are reported on the **Form 1099** series and **Form W-2G** information returns, payments may be subject to backup withholding if:

- The payee does *not*: (1) Give their TIN to the payer in the required manner; or (2) Certify that they are *not* subject to back-up withholding for underreporting interest and dividends. In such cases, the IRS informs the payer that: (1) The payee gave an incorrect TIN and did *not* certify their TIN as required; and (2) They must begin back-up withholding because the payee did *not* report all their interest and dividends on their tax return. **(Misc.; Information Returns)**

> **Comment:** Keep in mind that payers are ultimately responsible for any amount they fail to backup withhold and the penalties that may apply.

☞**Outsourcing Payroll Tax Duties**

Many smaller businesses choose to outsource their payroll tax responsibilities to third-parties. This would include: (1) payroll service providers; (2) reporting agents; (3) certified professional employer organization; and (4) Section 3504 agents. The key is to select a trusted payroll service provider and then stay on top of their actions to ensure that all payroll related functions are being done properly and on a timely basis. The IRS also has a handy reference tool called the **Third Party Arrangement Chart** which outlines the various duties that these third-party payroll service providers can cover. One of the key issues to address is that all correspondence from the IRS goes directly to the taxpayer's business address (and, *not* merely to the payroll service). Also, any business using these outside agents should enroll in the **Electronic Federal Tax Payment System** to monitor deposits and make sure that they are being made on a timely basis. **(Misc.; Payroll Taxes)**

☞**IRS Recommendation to E-file Payroll Tax Returns (Tax Tip 2022-74)**

The IRS is advising business owners that they "can simplify their payroll tax compliance" by e-filing their payroll tax returns. Employers can purchase e-file software that performs calculations and populates forms and schedules using a step-by-step process. This software also provides the filer with an email confirmation, generally within 24 hours of filing, that the IRS has received the return.

The most common types of employment tax returns can be e-filed include:

- **Form 940, Employer's Annual Federal Unemployment Tax Return:** Employers use this form to report annual Federal Unemployment Tax Act tax.

- **Form 941, Employer's Quarterly Federal Tax Return:** Employers use this form to report income taxes, social security tax, or Medicare tax withheld from employees' paychecks. They also use it to pay their portion of Social Security or Medicare tax.

- **Form 943, Employer's Annual Federal Tax Return for Agricultural Employees:** Employers file this form if they paid wages to one or more farm workers and the wages were subject to social security and Medicare taxes or federal income tax withholding.

- **Form 944, Employer's Annual Federal Tax Return:** This form is only filed by very small employers whose annual liability for Social Security, Medicare, and withheld federal income tax is $1,000 or less. Employers must have the IRS's permission to use this form.

Employers who want to e-file their own payroll tax returns will need to purchase IRS-approved software. A list of IRS-approved software providers can be found **here**. In addition, employer will need to sign the returns, which can be done in one of two ways as follows:

1. The employer can use their e-filing software to apply for an online signature PIN from the IRS which can take at least 45 days. The employer will use this PIN to sign any e-filed payroll tax returns.

2. The employer can complete, sign, scan and upload with their return **Form 8453-EMP, Employment Tax Declaration** for an IRS e-File return. The employer will physically sign the **Form 8453-EMP** and attach it to their e-filed payroll tax return.

> **Comment:** If the employer does *not* want to buy special software to e-file their payroll tax returns, they can obviously have their tax professional file the returns for them. If that is the case, these employers will need to provide their tax professional with a signed and dated **Form 8879-EMP**, along with IRS e-File Signature Authorization for **Forms 940, 940-PR, 941, 941-PR, 941-SS, 943, 943-PR, 944**, and **945**.

☞**Reason Behind Long Delay Processing Forms 941-X**

The IRS still has numerous unprocessed **Forms 941-X**. In fact, there were 199,000 of them as of Sept. 21st. Many of these quarterly payroll tax returns were filed by employers to amend their original filings to claim temporary COVID breaks, such as the sick and family leave credit and the employee retention tax credit. The Service is now making some headway on these returns, since as of Feb. 1st, there had been over 447,000 of these amended payroll returns. It is now becoming clear why there is such a long processing delay. The IRS delayed working on these claims for the credits until 12 months after the legislation granting these tax breaks was enacted, according to Treasury inspectors.The main culprit behind this delay was found to be "a lack of updated computer programming, guidance and training." **(Misc.; Form 941-X)**

Code §1402 - Self-Employment Taxes:

☞When Short-term Rental Income Is Subject to S/E Tax (CCA 202151005)

This IRS Chief Counsel Advice outlines, in two examples, when income from short-term rentals is included in self-employment income.

> **Comment:** Take a look at **Form 1040, Schedule 1, Line 8k** which now has a specific listing for "personal property rentals" (e.g., equipment and vehicles) that would *not* be subject to self-employment tax.

Net Earnings from Self-employment: Code §1401(a) imposes a tax on an individual's net earnings self-employment (NESE). However, under **Code §1402(a)(1)**, "net rental income," generally is *not* included in NESE, unless:

1. The income is received by a "real estate dealer," or

2. The rent includes "substantial" (i.e., "significant personal") services provided to the occupant for the occupants' convenience.

Examples of rentals where "substantial services" are rendered for the occupants' convenience include hotels, motels, boarding houses, and BnB's. Sometimes, warehouses and storage garages might be included as well, depending on the circumstances. (**Reg. §1.1402(a)-4(c)(2)**)

Rental Activities: A rental activity is automatically *not* treated as a passive activity if the average period of customer use of the property is *seven days or less*. In addition, a rental activity (which is treated instead as a trade or business) would *not* be considered passive if the taxpayer "materially participates" in the activity. (**Code §469(a)(7)**)

> **Comment:** But keep in mind that, under **Reg. §1.469-1T(d)(1)**, characterizing items of income or deduction as passive activity income or deductions only affects the treatment of those items for purposes of the passive activity loss rules.

Example #1: An individual, who is *not* a real estate dealer, has a business renting a fully furnished vacation property via an online rental marketplace (e.g., AirBnB or VRBO). The individual provides daily maid service, access to dedicated Wi-Fi, beach and recreational equipment for occupants' use during their stay and prepaid vouchers for ride-share services between the property and the nearest business district. For the year at issue, customers used the vacation property on average for seven days. As a result, the activity is *not* automatically considered a "rental activity" for purposes of the passive activity loss rules in **Code §469**. Instead, it is "elevated" to the same status as any other trade or business activity would be under the PAL rules.

In this example, Chief Counsel notes that the taxpayer provides services for occupants that:

1. Are *not* clearly required to maintain the space in a condition for occupancy, and

2. Are of such a "substantial nature" that the compensation for those services "constitutes a material portion" of the overall rent paid.

Therefore, the net rental income in this instance is included in NESE (and, must be reported on **Schedule C** as a business and subject to self-employment tax on Schedule S/E).

Example #2: An individual, who is *not* a real estate dealer, has a business renting a fully-furnished room and bathroom in their dwelling via an online rental marketplace. Renters only have access to the common areas of the home to enter and exit the room and bathroom, but they do *not* have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay. For the year at issue, the average period of customer use of the vacation property is seven days and the taxpayer materially participates in the activity. Therefore, the activity is *not* automatically a passive activity for purposes of the passive activity loss rules. Moreover, in this situation, the taxpayer's net income from renting living quarters is excluded from NESE because only minimal services are rendered to the occupants. The taxpayer cleans and maintains the property so that it remains suitable for occupancy. Therefore, these services are *not* furnished primarily for the occupants' convenience. **(Code §1402; S/E Tax)**

☞Final Regs Issued on S/E Tax for Partners in Partnership Owning SMLLCs (TD 9869)

The IRS has issued final regs that provide that partners in a partnership that owns a disregarded entity are *not* employees of the disregarded entity for employment tax purposes and are, instead, subject to self-employment tax based on their share of income from that partnership (i.e., K-1, Boxes 1 and 4, as totaled in Box 14). **(Code §1402; S/E Tax)**

☞Self-Employment Tax Audits for Professional LLCs Put On Hold

The IRS has announced that it is pausing any new self-employment tax audits of professional LLCs and LPs. The Service has an on-going active audit campaign on when LLC members and limited partners in "professional service firms" (e.g., those practicing consulting, medicine, law, accounting, etc.) owe self-employment tax on their distributive share of the firm's income. In 2017, the Tax Court ruled that law members who actively participated in an LLC's operations should *not* be treated as "mere investors" and were therefore liable for self-employment taxes. Hundreds of professional service companies had been selected for these SECA audits. Some of these cases involving LPs are at the trial stage. In the meantime, the IRS is temporarily halting new audits, taking a wait-and-see approach while courts decide the cases before them. Several audited cases are before IRS's appeals office. **(Code §1402; S/E Tax)**

Comment: The current rules on self-employment tax lack sufficient clarity for owners of LLCs and LPs, especially in light of the stance that the IRS is taking in audits, appeals and the courts. Generally, a limited partner's distributive share of partnership income is *not* subject to SECA tax. But the tax code fails to specifically address exactly who is a "limited partner" for this purpose. The IRS issued proposed regs in 1997, but these rules were never finalized. Now, the IRS has indicated that it will revisit this issue. It announced in its "annual regulatory priority list" that it will review the application of SECA tax under the relevant statute. The Service's position in the courts is that the SECA exemption for limited partners and LLC members applies only to passive investors who are *not* otherwise involved in the day-to-day activities of the underlying business, and that state law classification is irrelevant.

Comment: Under the **proposed regs** for S/E tax there is an example where a managing member of an LLC can simultaneously hold an "investor member" interest. The result is that while S/E tax would be owed on their derivative K-1 share of net income, it would *not* be due on the K-1 profits attributable to the "investor member" share. A key factor is that this "investor member" share is exactly the same as those interests held by owners who are truly just passive investors in the underlying business of the LLC.

Code §3121 - Independent Contractor v. Employees:

☞Proposed Worker Classification Rules (RIN 1235-AA43)

The U.S. Department of Labor (DOL) has published a proposed rule to revise the guidance on how to determine who is an employee or independent contractor under the **Fair Labor Standards Act (FLSA)**. The proposal would rescind an earlier rule on this topic that was published on 1/7/21 and replace it with "an analysis for determining employee or independent contractor status that is more consistent with the FLSA as interpreted by longstanding judicial precedent." The DOL asserts that its proposed rule "would reduce the risk that employees are misclassified as independent contractors, while providing added certainty for businesses that engage with individuals who are in business for themselves." The proposed rule was issued because the worker classification rule from 2021 "is *not* completely consistent with the FLSA's text and purpose as interpreted by courts and departs from decades of case law applying the economic reality test." **(Code §3121(d)(2); Independent Contractors)**

> **Comment:** This issue is huge for companies like Uber and Lyft which currently treat most of the drivers as independent contractors (except for CA which passed a law making them employees). Even though this classification as **employees** might result in fringe benefit and health insurance coverage, most of the drivers seem to prefer be their own bosses. It would be interesting to see how these rules will be applied as opposed to the **"20-factor common law tests."**

> **Comment:** There are some major concerns that this rule fails to understand the modern workforce, the comment period for the rule is too short for meaningful analysis, and the rule will lead to layoffs in some industries. Obviously, it would also cost the employers now an additional 7.65% for their share of Social Security and Medicare taxes, along with the costs associated with health insurance, retirement plans and fringe benefits.

☞IRS Guidance on Classification of Common Law Employees

The IRS Office of Federal, State, and Local Government recently hosted a webinar offering guidance on which workers are or are *not* considered employees for classification purposes under **Code §3121(d)(2)** using the application of common law standards and factoring the circumstances surrounding the work performed (i.e., the "20-factor rules").

> **Comment:** Using Uber or Lyft as examples, how would you treat these workers?

Under common law rules, whether an individual is an employee or an independent contractor is determined by the relationship of the worker with regard to the business, and if the business can direct or control how the worker performs a task.

The IRS considers several aspects of the relationship between parties that can inform how a worker is classified, such as:

(1) The substance of the relationship, rather than its label;

(2) Whether a worker receives benefits (e.g., health insurance, pension plan, vacation/sick pay);

(3) The permanency of the relationship; and

(4) The extent to which a worker's services are a key aspect of the regular business of the

company.

Behavioral Control: A business has what the IRS labels as "behavioral control" of an employee if it can place restrictions on what equipment can be used, where supplies can be purchased, or protocol to follow. Formal training is also indicative of an employee relationship.

Risk of Loss: An independent contractor can make a profit or loss and are paid a flat fee or a contract price, while employees do *not* incur such risk and are paid a regular wage.

Independent Contractors: Independent contractors are, generally (i.e., there is no formal definition), self-employed individuals who have been contracted to perform services for a taxpayer. This would include, for example, doctors, veterinarians, and auctioneers working in an independent trade, business, or profession in which services are offered to the public. Because independent contractors control the means and methods of how to accomplish an assigned task or project, they are *not* classified as employees.

Statutory Non-employees: "Statutory non-employees" are specifically excluded from the definition of "employee" for tax purposes. There are three categories of statutory non-employees:

Direct sellers: Individuals engaged in selling consumer products in the home or place of business other than in a permanent retail establishment (including newspaper or shopping news distributors);

Qualified real estate agents: Individuals engaged in appraisal activities for real estate sales, with at least 90% of earned income coming from commissions on sales or other outputs; and

Specified companion sitters: Individuals who furnish personal attendants, companionship, household care services to children, elderly, and/or disabled persons.

Statutory Employees: Individuals falling under one of the following categories are considered employees (at least for employment tax purposes):

Agent drivers: Individuals who distribute beverages other than milk, meat, vegetables, fruit, or bakery products, or who pick up and deliver laundry or dry cleaning.

Full-time life insurance sales agents: Individuals whose principal business activity is selling insurance or annuity contracts, or both.

At-home contractors: Individuals who work at home on materials or goods that must be returned to a customer.

Full-time traveling sales agents: Individuals who work on someone's behalf and turns in orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments.

Comment: Statutory employees are treated as employees for Social Security and Medicare tax purposes. But they file a **Schedule C** with their personal return as if they are self-employed. Unlike regular employees, who cannot deduct their unreimbursed expenses on **Schedule A** (i.e., since 2% miscellaneous deductions on **Form 2106** were eliminated for most taxpayers), statutory employees can instead deduct business costs on **Schedule C**. Furthermore, they can potentially qualify for the **Code §199A** 20% deduction on "qualified business income."

Corporate Officers: Officers of a corporation are to be treated as employees unless *both* of the following situations apply:

(1) The officer does *not* perform any services or performs only "minor services;" and

(2) The officer is *not* entitled to receive (directory or indirectly) any remuneration.

Comment: Services are "minor or nominal" depending on the character of the service, the frequency and duration of performance, and the how important such services are to the conduct of the corporation's business.

Governmental Employees: Code §3401(c) provides that an elected or official of a state or local government is an employee. The same is true of public officers that have been elected or appointed.

Form SS-8: Form SS-8 can be filed with the IRS by either the worker or the entity for which the worker performs services for an official will receive a binding response as to whether the worker is an employee.

Voluntary Classification Program: The **Voluntary Classification Settlement Program (VCSP)** allows taxpayers that treat its workers as independent contractors or other non-employees to instead reclassify them as employees. However, an eligible taxpayer wishing to do this "reclassification" must have filed **Form 1099-NEC** for each applicable worker it has treated as a non-employee (i.e., independent contractor) for the previous three years. To apply, a taxpayer must submit a **Form 8952** and enter into a closing agreement with the IRS. **(Code §3121; Independent Contractors)**

Comment: Business clients should be advised to use **Form 1099-NEC (Non-Employee Compensation)** by 1/31/2022 to report compensation of $600 or more to non-employees (i.e., instead of **Form 1099-MISC**). Meanwhile, such payments could be subject to backup withholding in certain instances if the payee has failed to provide a Taxpayer Identification Number to the payer or if the IRS notifies the payer that the payee provided a TIN (e.g., Social Security, employer identification, individual taxpayer identification and adoption taxpayer identification) that does *not* match their name in IRS records.

Comment: For 2021 tax returns, there is no automatic 30-day extension to file **Form 1099-NEC**, although a filing extension may be available "under certain hardship conditions."

☞Properly Classifying Workers Who Receive Both W-2 and Form 1099-MISC

The IRS has outlined what issues an IRS examiner should look at when determining the **classification** of a worker (as either an employee or independent contractor) when the employer files *both* a **Form W-2, Wage and Tax Statement**, and a **Form 1099-MISC, Miscellaneous Information**, for the worker for the *same* year.

Comment: Even though the IRS mentions **Form 1099-MISC**, it would probably be more **accurate** to issue a **Form 1099-NEC** in instances such as this, at least starting for the 2020 tax year. Although this would be an unusual situation where an employee (or, former employee) received *both* a W-2 and a Form 1099 in the same tax year, the "20-factor common-law test" for distinguishing an employee v. an independent contractor is important to keep in mind, especially where more workers are performing their duties remotely. Namely, this issue might arise as to whether their employment status had possibly changed to that of being an independent contractor.

Background - Employee v. Independent Contractor: Generally, an employer is required to withhold income and employment taxes from its employees. (**Code §3402**) When determining how to classify a worker (i.e., as an employee or an independent contractor), the Tax Court looks at various factors including:

1. The degree of control exercised by the principal over the details of the work;
2. Which party invests in the facilities used in the work;
3. The opportunity of the worker for profit or loss;
4. Whether or not the principal has the right to discharge the worker;
5. Whether the work is part of the principal's regular business;
6. The permanency of the relationship; and
7. The relationship the parties believe they are creating.

Comment: This is the exact analysis which was in play for the Uber and Lyft drivers in CA.

The Tax Court stressed that "no single factor is dispositive, and all facts and circumstances must be considered." But, the extent to which the principal has the right to exercise control over the worker is the "crucial test" in determining the nature of a working relationship. (***Weber*, 103 TC 378 (1994)**, ***aff'd*** **76 AFTR 2d 95-5782 (4th Cir., 1995)**)

If a worker is classified as an employee, then the employer files a **Form W-2, Wage and Tax Statement**, with the IRS to show the amount of taxes withheld from the employee's wages. If instead a worker is classified as an independent contractor, then the person paying the worker income files a **Form 1099-MISC, Miscellaneous Information**, to show the amount of wages the worker received, and any income taxes withheld.

Issue: What if an employer files *both* a **Form W-2** and **Form 1099-MISC** for a worker in the *same* tax year? How should IRS classify the worker?

IRS Analysis: When the taxpayer files *both* **Form W-2** and **Form 1099-MISC** for a worker, the examiner should consider whether:

1. The worker was treated as an employee for part of the year and an independent contractor for a separate part of the year (i.e., payments reported on **Form W-2** and **Form 1099-MISC** were for the *same* services but distinct periods of time during the year).

2. The worker was performing two or more *distinct* services and the taxpayer considered the worker to be an employee for one service and an independent contractor for the other service (i.e., "dual-status worker").

3. The payment reported on **Form 1099-MISC** represented additional compensation to the worker in his capacity as an employee for which he received compensation reported on **Form W-2** (e.g., a "bonus payment"). **(Code §3121(d)(2); Employee v. Independent Contractor)**

Comment: Even though this is what the IRS advised for its auditors, if an employee got a yearend bonus, for example, that should probably go on their W-2 and *not* a **Form 1099-MISC**.

☞**Physician's Office Workers Were Employees (*Cardiovascular Center, LLC*, T.C. Memo 2023-64 (5/24/2023))**

The taxpayer had an office manager and four medical assistants. All of the workers were supervised by a physician who was the sole member of this LLC taxpayer and followed office procedures that were established by the physician and office manager. None of the workers realized a profit or loss, there were no formal employment contracts, and they were paid hourly with overtime based on time sheets. The workers, however, determined their own schedules, where they were permitted to arrive and leave, at any time, without adverse consequences. The taxpayer insisted that it was *not* the employer of these workers and it did *not* file or furnish **Form 1099-MISC** nor did it file any employment tax returns for the tax periods at issue. The Tax Court agreed with the IRS that the office manager and the medical assistants should have been treated as employees. Additionally, the physician did *not* qualify for employment tax relief under IRC Sec. 530 (i.e., it could *not* be shown that he was simply following standard industry practice in this area, nor did he ever issue **Form 1099s** given that the workers were supposedly independent contractors). **(Code §3121(d)(2); Independent Contractors)**

☞**Home Health Care Nurses Treated as Employees (*Pediatric Impressions Home Health, Inc.*, T.C. Memo 2022-35 (4/12/2022))**

The Tax Court has confirmed the IRS' determination that the taxpayer failed to classify correctly approximately 99 individuals as employees during tax years 2016-2018 (i.e., the company had instead been treating them as independent contractors). As a result, the company was liable for federal employment taxes, additions to tax, failure-to-deposit penalties, and accuracy-related penalties. The company was involved in the business of providing at-home private duty nursing services to children with special needs. They hired nurses to perform services on its behalf and set the nurses' work schedules, which varied for each nurse. Among the "common law 20-factor tests," the Court found that the key indications demonstrating that they were employees included: (1) the degree of control exercised by the alleged employer; (2) the degree to which the worker's opportunity for profit or loss is determined by the alleged employer; (3) the extent of the relative investments of the worker and the alleged employer; (4) the permanency of the relationship; and (5) the skill and initiative required in performing the job. **(Code §3121(d)(2); Independent Contractors)**

> **Comment:** This can certainly be an area of confusion where the IRS has listed among the various "Statutory Non-employees" the category of "Specified Companion Sitters" which would include "individuals who furnish personal attendants, companionship, household care services to children, elderly, and/or disabled persons." The difference in this situation was probably due to the fact that these professionals were skilled nurse and *not* just "companion sitters."

> **Comment:** This "Statutory Non-employee" exception gives the elderly some peace of mind that they do not have to contend with any "nanny tax" or worrying about third-parties who might be assisting them with day-to-day activities having to be treated as employees for tax purposes.

☞**Workers for Apartment Cleaning Business Independent Contractors Not Employees (*Santos*, TC Memo. 2020-88 (6/17/2020))**

Although it took filing a petition with the Tax Court, a woman who operated her own business which contracted with apartment complexes to clean vacated units was able to convince the Court of her position. She hired workers with prior cleaning experience, but she did *not* provide training, leave or benefits. In addition, the workers could put in as many or as few hours as they wanted and could work with other firms, as well as being able to drive their own cars to the job sites and paid for supplies. Moreover, the business owner did *not* inspect or otherwise supervise the cleaning jobs. Consequently, she provided the workers with 1099s and always treated them as independent contractors. **(Code §3121(d)(2); Independent Contractors)**

Code §3401 - Withholding Taxes:

☞**Significant Tax Gap with Unpaid Employment Taxes**

Unreported (or, underreported) employment are becoming a significant portion of the "tax gap" (i.e., what is owed to the IRS and what is actually paid). In fact, it is estimated that $87 billion of payroll taxes remained unpaid on an annual basis for the latest years of a recent study (i.e., 2014 to 2016). About $60 billion is from unpaid self-employment tax. And, as more freelance types of service gigs become available, the shortfall is certain to go higher. New **Form 1099-K** reporting will help to spot the cheaters, as well as an increased portion of the IRS dedicated to auditing this area of the tax law. **(Code §3401; Employment Taxes)**

☞IRS Releases Updated Draft Form 941-X Instructions

The IRS has released draft **instructions** for **Form 941-X** **(Adjusted Employers Quarterly Federal Tax Return or Claim for Refund)**. The revised instructions contain a number of changes to the **"qualified small business payroll tax credit"** for increasing research activities for tax year 2023 and beyond. Previously, "qualified small businesses" could claim up to $250,000 of the credit for research activities as a credit against payroll taxes. Beginning in 2023, the **Inflation Reduction Act of 2022** increases that limit up to $500,000. The credit may be used to first reduce the *employer* share of social security tax up to $250,000 per quarter, and the remaining $250,000 against the *employer* share of Medicare tax. Any amount *not* used may be carried forward to the next payroll tax quarter. **(Code §41; R&D Expenses)**

☞What to Know Regarding "Back-up Withholding" (Tax Tip 2021-156)

The IRS recently released a **"Tax Tip"** entitled **"What Taxpayers Should Know about Back-up Withholding."** **Back-up withholding** ensures that the government is paid the correct amount of taxes on specific types of payments reported on certain **Forms 1099** and **W-2G**. Here are some important facts about backup withholding and why it is required on certain non-payroll amounts when certain conditions apply. The payer making such payments to the payees does *not* generally withhold taxes, and the payees report and pay taxes on this income when they file their federal tax returns. There are, however, situations when the payer is required to withhold a certain percentage of tax to make sure the IRS receives the tax due on this income. Backup withholding is set at a specific percentage with the current percentage being 24 percent.

Payments subject to backup withholding include:

- Agriculture payments
- Attorneys fees and gross proceeds paid to attorneys
- Barter exchanges
- Commissions, fees or other payments for work done as an independent contractor
- Dividends
- Gambling winnings, if not subject to gambling withholding
- Interest payments
- Original issue discount
- Patronage dividends, but only if at least half the payment is in money
- Payment card and third-party network transactions
- Payments by brokers
- Payments by fishing boat operators, but only the part that is paid in actual money and that represents a share of the proceeds of the catch
- Rents, profits or other gains
- Royalty payments
- Taxable grants

Examples when the payer must deduct backup withholding:

- If a payee has *not* provided the payer a Taxpayer Identification Number at the time the reportable payment is made, or the payee provided an "obviously invalid TIN" to the payer. A TIN specifically identifies the payee and includes Social Security numbers, Employer Identification Numbers, Individual Taxpayer Identification Numbers and Adoption Taxpayer Identification Numbers. An "obviously invalid TIN" is one that has fewer than nine digits, more than nine digits, or contains non-numeric characters.

- If the IRS notified the payer that the payee provided a TIN that does *not* match their name in IRS records, and the payer does *not* secure the correct TIN from the payee. Payees should make sure that the payer has their correct name and TIN to avoid backup withholding.

- If the IRS notifies the payer that the payee has underreported income from interest and dividends.

Payer's liability for backup withholding:

- If a payment was subject to backup withholding, but the payer did *not* deduct backup withholding as required from the payment, the payer instead becomes liable for the tax. **(Misc.; Back-up Withholding)**

☞**Rules for Non-employee Compensation and Back-up Withholding** (**Tax Tip 2022-109**)

When a business hires an independent contractor, the employer is generally *not* responsible for withholding income taxes, Social Security, or Medicare taxes from their compensation. However, by law, business taxpayers who pay non-employee compensation of $600 or more in the course of their "trade or business" (i.e., which a Schedule E rental is *not* considered to be) to a *noncorporate* taxpayer (e.g., partner in a partnership, or a Schedule C/F proprietor) must report these payments to the IRS. They do this using **Form 1099-NEC, Non-employee Compensation**.

> **Comment:** As long as a *corporate* taxpayer has a valid (i.e., done within the most recent two years) **W-9** on file with the payor, there is no **Form 1099** reporting requirement.

Generally, payors must file **Form 1099-NEC** by January 31st. There is no *automatic* 30-day extension to file **Form 1099-NEC**. However, an extension to file may be available under certain "hardship conditions."

Non-employee compensation reportable on **Form 1099-NEC** is subject to "backup withholding" if a payee has *not* provided a Taxpayer Identification Number to the payor or the IRS notifies the payor that the payee provided a TIN that does *not* match their name in IRS records. A TIN can be one of the following numbers:

- Social Security
- Employer identification
- Individual taxpayer identification
- Adoption taxpayer identification

What is backup withholding? **Backup withholding** can apply to most kinds of payments reported on **Forms 1099** and **W-2G**. The person or business paying the taxpayer does *not* generally withhold taxes from certain payments. Nevertheless, there are situations when the payer is required to withhold a certain percentage of tax to make sure the IRS receives the tax due on this income. The payer's requirement to withhold taxes from payments *not* otherwise subject to withholding is known as "backup withholding." The current backup withholding tax rate is 24%. **(Code §3401; Back-up Withholding)**

> **Comment:** More detailed information can be found in the following publications:

Instructions for Forms 1099-MISC and 1099-NEC

General Instructions for Certain Information Returns

IRS Pub. 15, Employer's Tax Guide, Circular E

☞**Proposed Regs Update Income Tax Withholding Rules (IR 2020-28)**
The IRS has issued proposed regulations that update the federal income tax withholding rules to reflect changes made by the **Tax Cuts and Jobs Act**, as well as other recent legislation. The proposed rules are designed to accommodate the redesigned **Form W-4** **(Employee's Withholding Certificate)** and the related tables and computational procedures in **IRS Pub. 15-T** **(Federal Income Tax Withholding Methods)**. Among other things, the proposed regulations: (1) provide rules on when employees must furnish a *new* **Form W-4** for changed circumstances, (2) update the rules for the "lock-in letter program," and (3) eliminate the combined income tax and FICA tax withholding tables. In addition, the proposed regs do *not* require current employees to furnish a new **Form W-4** in 2020 "solely because of the form's redesign." **(Code §3401; Form W-4)**

Comment: Taxpayers may rely on the proposed regs in their entirety until they are adopted as final.

☞**In-home Care Payments Subject to Employment Taxes (CCA 202243009)**
Given that an employment relationship exists, in-home care payments to service providers, whether related or not, should generally be treated as remuneration for services rendered and therefore subject to *both* income and FICA and FUTA taxes absent an applicable exception. In this Chief Counsel Advice (CCA) it was noted that **Notice 2014-7** stated certain in-home care payments to service providers, including parents who receive payments from the Medicaid waiver program for the care of their child, are treated as "difficulty-of-care payments" under **Code §131** and therefore *not* includible in gross income for federal income tax purposes. However, the Notice did *not* address the FICA or FUTA tax treatment of these in-home care payments. The CCA concludes that these payments are still generally subject to FICA and FUTA taxes unless an exception applies. **(Code §3401; In-home Health Care)**

Code §6672 - Failure to File Tax Return or Pay Tax:

☞**Temporary Hospital Administrator Liable for Unpaid Payroll Taxes (*Cashaw*, (5th Cir., 5/31/2023))**
This temporary hospital administrator was held liable for the 100% trust fund penalty for "willful failure to deposit." The woman took over as the temporary administrator for 18 months before quitting her position. Her duties included payroll, signing checks with another signatory, paying expenses and more. Though she was aware that federal taxes withheld from workers' paychecks were *not* paid to the IRS, she claims she was *not* a "responsible person" who willfully failed to remit the taxes. An appeals court disagreed, saying that when she authorized checks for payment of vendors and employee wages, knowing at the time that payroll taxes were unpaid, she "willfully failed to pay the trust fund taxes." **(Code §6672; Trust Fund Penalty)**

Comment: She was found liable for $173,630 in unpaid payroll taxes. She began at the hospital in 1978 as a pharmacist and took on increasing leadership responsibilities throughout her time there. In October 2012, the hospital's chief administrator was indicted in a scheme to defraud Medicare and was removed from the position. She then took his place and was given *nonexclusive* signature authority. As temporary chief administrator, she oversaw payroll, reviewed expenses, attended board meetings and was one of two individuals whose signature was required on all checks. She resigned in April 2014, alleging a "toxic environment" at the hospital that included "undue stress, interference, [and] lack of integrity." She testified that she was in a "difficult position" as chief administrator and had to decide whether to pay the taxes or instead concentrate on patient care. The court disagreed, saying she "had a duty to ensure the taxes were paid before authorizing payments to vendors or employees."

☞**Nursing Home Officer's Nonpayment of Withholding Taxes Not Willful - Trust Fund Penalty Not Applied (*Preimesberger*, 126 AFTR 2d 2020-5143 (DC CA, 08/05/2020))**

A district court has concluded that a nursing home officer's failure to pay withholding taxes was *not* "willful" as a matter of law. The officer paid other creditors before the IRS while trying to comply with mandatory federal and state regulations that required him, despite a severe cashflow problem, to keep the nursing homes operating at the existing standard of care.

Facts: The taxpayer was employed by Meridian Health Services Holdings, Inc. ("Meridian") to operate five skilled nursing home facilities in California. From 2010 through 2015, "the facilities accrued substantial Medicare and Medi-Cal receivables due from the United States." But eventually the cashflow problem became so acute that the facilities could *not* meet all their operational expenses. As a result, the taxpayer arranged for Meridian to bridge the cashflow situation by drawing on a line of credit from a bank. However, the bank would only authorize and provide funds "for the payment of net wages and other expenses necessary to maintain the facilities' standard of care." As a result, the facilities was *not* permitted to use the funds to pay their withholding tax obligations. And, the taxpayer insisted that the facilities "could *not* simply cease operations to resolve its cashflow problems." As mentioned above, under various federal and state regulations, the facilities "had to remain open and maintain the existing standard of care for all residents, despite its cashflow problems, until it complied with regulatory closing procedures and could officially close." Furthermore, violations of these regulations carried civil and criminal penalties. Nevertheless, in 2019, the IRS assessed "trust fund recovery penalties" against the taxpayer for the second, third and fourth quarters of 2014 and the first and second quarters of 2015.

District Court Decision: The Court found that failure to pay withholding taxes *not* "willful" as a matter of law. The available evidence confirmed that the facilities could *not* just cease operations because federal and state regulations (i.e., "nursing home regulations") prevented nursing homes and skilled nursing facilities from simply closing their doors. Instead, the nursing home regulations required such facilities:

1. To follow a specific closing process; and
2. To maintain the existing standard of care until closure.

Based on this evidence, the court determined that the taxpayer "had to keep the facilities open and maintain the standard of care until he could comply with the regulatory process for closing them." And, since there was no evidence that the taxpayer had any funding options other than the bank's line of credit, the court agreed that the only way that he could meet his obligations under the nursing home regulations was to comply with the restrictions that the bank placed on the funds he borrowed. **(Code §6672; Trust Fund Penalty)**

Comment: It was a shame that the taxpayer could not have settled this issue at the IRS audit or appeals level, but instead had to go through the expense and time involved by taking this matter to court. The IRS never alleged that the taxpayer had access to any funds, other than the bank loan, that he could use to pay the withholding taxes.

☞**Part-time Bookkeeper Liable for Employer's Unpaid Payroll Taxes (*Kazmi*, TC Memo. 2022-13 (3/1/2022))**

This employee ending up owing the 100% trust fund penalty for “willful failure” to deposit the company’s withheld payroll taxes to the government. He was an hourly employee of a doctor’s office who took care of the business’s payroll. And, although he knew that taxes withheld from workers’ paychecks were *not* remitted to the IRS, he claimed that he should *not* be treated as a “responsible person” who “willfully failed” to pay over the taxes. His arguments included that he was *not* an officer or director, he had no ownership stake in the business, he had no check-signing authority, and he could *not* make payments on the company’s behalf. Nevertheless, the Tax Court agreed with the IRS, holding that its collections settlement officer acted properly and did *not* abuse their discretion. **(Code §6672; Trust Fund Penalty)**

> **Comment:** The “moral of the story” here is that it might be advisable to quit your employment in a business such as this rather than face the 100% trust fund penalty.

Another CFO Suffers Dreaded 100% Trust Fund Penalty (*McClendon*, Civil Action No. H-15-2664 (DC TX, 1/22/2019))

The District Court here confirmed the IRS finding that a company’s chief financial officer was a “responsible person” and therefore should be held liable for 100% of the unpaid employment taxes. As usual, the key factors were that he had control over the company’s bank account and oversaw all aspects of the business’ operations and finances, including payroll, tax return preparation and personnel matters. More importantly, he knew that the firm had failed to deposit its payroll taxes and file the necessary employment tax returns. He had check-signing authority and decided to pay other creditors *before* the IRS. As a result, he was 100% liable for payment of the payroll taxes. **(Code §6672; Trust Fund Penalty)**

Notes:

TAX-EXEMPT ENTITIES:

Miscellaneous:

☞**Additional Information Provided on Exempt Organization NOLs (AM 2020-008)**

The IRS has expanded upon what it previously stated in frequently asked questions (FAQs) that were posted to its website in June, about the effect of net operating losses (NOLs) on the calculation of a tax-exempt organization's unrelated business taxable income (UBTI).

Background: A tax-exempt organization (EO) may engage in more than one "unrelated trade or business." Before the law was changed by the **Tax Cuts and Jobs Act**, an EO deriving gross income from the regular conduct of two or more unrelated trades or businesses calculated UBTI by determining its *aggregate* gross income from *all* such unrelated trades or businesses and reducing that amount by the *aggregate* deductions allowed with respect to *all* such unrelated trades or businesses. (**Reg. §1.512(a)-1(a)**)

Code §512(a)(6), which was added by **Sec. 13702** of the **TCJA**, changed the calculation of UBTI for EOs with *more than one* unrelated trade or business. **Code §512(a)(6)** now requires an EO with more than one unrelated trade or business to calculate UBTI *separately*, including for purposes of calculating any NOL deduction, with respect to each unrelated trade or business in tax years beginning *after* December 31, 2017. This calculation method is sometimes referred to as "siloing."

Sec. 13302 of the **TCJA** made extensive changes to **Code §172** regarding the NOL deduction, including generally *repealing* NOL carrybacks (except with respect to certain farming losses and certain insurance companies) while permitting *indefinite* carryforwards.

On March 27, 2020, **Code §172** was then amended again by the **CARES Act** and now provides that any NOL arising in a tax year beginning *after* December 31, 2017, and *before* January 1, 2021 (i.e., 2018, 2019 and 2020 tax years), may be carried back to the five tax years preceding the tax year of such loss. As a result of this rule, carrybacks may be made to tax years prior to the date of enactment of **Code §512(a)(6)**. **(Code §512; UBIT)**

> **Comment:** For more detailed information regarding the utilization of NOLs against any "unrelated business income tax" (UBIT) that a tax-exempt entity might otherwise incur, refer to **AM 2020-008**.

Code §170 - Tax-exemption and Crowd Funding

☞ **IRS Issues Fact Sheet on Taxation of "Crowd Funding" (Fact Sheet 2022-20)**

Crowdfunding is a method of raising money through websites by soliciting contributions from a large number of people to fund businesses, for charitable donations, or for gifts. Prior to 2022, the threshold for a crowdfunding website or payment processor to file and furnish a **Form 1099-K (Payment Card and Third Party Network Transactions)** was met if, during a calendar year, the total of all payment distributed to a person exceeded $20,000 in gross payments resulting from more than 200 transactions or donations. But, for calendar years beginning *after* 12/31/21, the threshold is *lowered* and is met if, during a calendar year, the total of all payments distributed to a person exceeds $600 in gross payments, *regardless* of the number of transactions or donations. **(Code §170; Crowd Funding)**

> **Comment:** The income tax consequences of crowdfunding depend on all the facts and circumstances and the IRS Fact Sheet goes into this in more detail. If a private individual, however, starts a crowd funding site and raises money (e.g., for families in need after a natural

disaster), it would be a taxable event with the funds having to be reported on their return (i.e., even if the funds were ultimately being used to help others). The key would be to have a sanctioned 501(c)(3) charity do this gathering of funds and then dispense the monies. There would be no tax effect to the charitable institution and no tax since these would be "gifts" to the recipient individuals eventually receiving the funds.

Code §501(c)(3) - Tax-Exempt Entities:

☞**Form 990-EZ Required to Be Filed Electronically**

The deadline for calendar-year tax-exempt groups is normally May 15th. Timely filing of these returns is crucial since the IRS can revoke the exempt status of such entities that fail to file three years in a row. Furthermore, these returns must be electronically filed. The e-filing rules apply to **Forms 990** for tax-exempt entities with tax years beginning *after* 2019, and to **Forms 990-EZ** for organizations with tax years ending *after* July 30, 2021. **(Code §501; Form 990)**

Comment: 2021 is the first tax year the **Form 990-EZ** has to be e-filed.

☞**IRS Highlighting Success of Form 1023-EZ**

The Service is signaling the success of **Form 1023-EZ**, which is the digital form that small organizations with annual gross receipts of $50,000 or less and assets of $250,000 or less can file in order to apply for Sec. 501(c)(3) tax exemption. However, churches, hospitals, schools, nonprofits organized as LLCs and others are *not* permitted to use **Form 1023-EZ** (i.e., they must instead use **Form 1023**).

In 2021, **Form 1023-EZ** filings comprised over 65% of all exemption applications received by the IRS with each submission taking an average of just 45 minutes for the Service to process. Nevertheless, the IRS has been found to be doing a poor job in reviewing these exemption applications. It "rubber-stamps the bulk" of all **Form 1023-EZ** filings, and then later conducts audits on a sampling of charities that received exemption. Some critics of the program claim that too many of these applications are being approved by IRS in error. As a result, **Form 1023-EZ** filers may soon have to include more information with the form. The Service is considering asking for: (1) the group's organizing documents; (2) articles of incorporation; and (3) and bylaws to help ensure the accuracy of the filings. **(Code §501(c)(3); Form 1023-EZ)**

☞**Form 1023-EZ Erroneously Filed in Many Instances**

It has come to light that numerous ineligible groups are filing **Form 1023-EZ**, which is the three-page application used for qualifying for tax-exempt status that is available for charities with annual gross receipts of $50,000 or less and total assets of $250,000 or less. Based on a 2019 study, up to 46% of **Form 1023-EZ** filings filed by small nonprofits were erroneously approved by the IRS, which point to the fact that the Service is simply "rubber-stamping" the applications. **(Code §501(c)(3); Form 1023-EZ)**

☞**Guidelines for Organizations Applying for Tax-exempt Status (Tax Tip 2023-100)**

Organizations applying for tax-exempt status must be organized and operated exclusively for any of the following purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, or preventing cruelty to children or animals.

Organizations that want to apply for recognition of tax-exempt status under **Code §501(c)(3)** will complete and file a **Form 1023-series application**. The **application process** on the IRS website includes a step-by-step guide explaining how to apply for tax-exempt status. The following list highlights the key steps in the process:

- **Form 1023**-series applications for recognition of exemption must be submitted electronically online at **Pay.gov**. The application must be complete and include the user fee.

- Some types of organizations do *not* need to apply for **Code §501(c)(3)** status to be tax exempt. These include churches and their **integrated auxiliaries**, and public charities with annual gross receipts normally no more than $5,000.

- Every tax-exempt organization needs an employer identification number (EIN), even if they do *not* have any employees. An EIN is a nine-digit number the IRS assigns for tax filing and reporting purposes. An organization must include their EIN on the application. Organizations can apply for an EIN **online**.

- The effective date of an organization's tax-exempt status depends on their approved **Form 1023**. If they submit this form within 27 months after the month they legally formed, the effective date of the organization's exempt status is the legal date of its formation. If an organization does *not* submit this form within those 27 months, the effective date of its exempt status is the date that it actually filed **Form 1023**.

- An organization that qualifies for tax-exempt status under **Code §501(c)(3)** will be classified as a "private foundation" unless the organization meets the requirements to be treated as a "**public charity**."

- A charitable organization must make certain documents available to the public. These include its approved application for recognition of exemption with all supporting documents and its last three annual information returns. **(Code §501(c)(3); Tax-exempt Status)**

> **Comment:** Refer to **IRS Pub. 557, Tax Exempt Status For Your Organization** for additional information on the "public inspection requirements." And, for more detailed information, the following sources are available: (1) **Applying for exemption - Frequently asked questions**; (2) **Form 1023 - Frequently asked questions**; (3) **Webinar: File Error-Free Form 1023-EZ Webinar**; (4) **StayExempt - Tax basics for exempt organizations**; (5) **Exempt organization public disclosure and availability requirements - Frequently asked questions**

☞**Time Frame for Obtaining Tax-Exempt Status**

If your organization has filed either a **Form 1023** or **1023-EZ** application for tax exemption, the Service's website should be checked for updates. The IRS receives about 100,000 applications for tax-exempt status each year, and as you might guess, it is behind on processing them. This is especially true for charitable organizations that submitted **Form 1023**. The **"Where's My Application for Tax-Exempt Status"** on the IRS website includes the guidelines and dates on when an applicant can expect to hear from the IRS. The tool also has a chart with the form number and latest postmark date of applications that have been assigned to specialists. **(Code §501(c)(3); Tax-Exempt Status)**

☞**Providing Funeral Benefits to Members Resulted in Loss of Entity's Tax-Exempt Status (Korean-American Senior Mutual Assn., TC Memo. 2020-129 (9/9/2020))**

The Tax Court agreed with the IRS that this arrangement with the group's members should result in the loss of the entity's 501(c)(3) exemption. The nonprofit was open to senior citizens age 55 to 90 with its members paying annual dues. When a member died, the group would make a payment directly to a funeral home to help with burial services. The amount of the benefit was based on how many years the decedent was a dues-paying member of the group, rather than any inability to pay for a funeral. As a result, the organization "was found to *not* be operating exclusively for charitable purposes." **(Code §501; Tax-Exempt Status)**

☞**Service Provides Guidance for Reinstating Automatically-Revoked Tax-Exempt Status (Rev. Proc. 2014-11)**

The IRS has provided procedures for *retroactively* reinstating the tax-exempt status of organizations that had their status *automatically* revoked under **Code §6033(j)(1)** for failure to file the required annual returns for *three consecutive* years.

Comment: As is explained in more detail below, organizations with gross receipts of less than $200,000 that failed to file Form 990-EZ or 990-N can get their exemptions back by filing **Form 1023** or **1024** with the appropriate fee within 15 months of the revocation. Larger groups, or ones that reapply for exemption outside the 15-month window, have other significant requirements to satisfy.

Background: Most organizations that are exempt from tax under **Code §501(a)** are still required under **Code §6033(a)** to file annual information returns. Under **Code §6033(j)**, an exempt organization's failure to file information returns for *three consecutive years* will result in the revocation of the organization's exempt organization status under **Code §501(a)**.

Comment: Over the past few years, the IRS has attempted to inform organizations of their filing responsibilities, and the consequence of failing to file. Nonetheless, many organizations have failed to comply and have had their tax-exempt status automatically revoked.

Rev. Proc. 2014-11: The IRS has now provided three procedures for reinstating the tax-exempt status of organizations that have had their tax-exempt status automatically revoked. An organization applies for reinstatement using the applicable application (i.e., **Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code**; **Form 1024, Application for Recognition of Exemption Under Section 501(a)**; or any other prescribed form or procedure regularly used to apply for recognition of exempt status as provided in **Rev. Proc. 2013-9**, or its successor).

In addition, an organization may apply for a "non-retroactive reinstatement" of its tax-exempt status effective from the date on which it files an application for reinstatement of its tax-exempt status (i.e., postmark date) at any time by using the process described in **Rev. Proc. 2014-11, §7** (i.e., "postmark date process"), regardless of whether it is eligible to use any of these three "retroactive reinstatement processes."

An organization whose tax-exempt status has been reinstated may have its tax-exempt status automatically revoked again if it again fails to file required annual returns or notices for another *three consecutive* tax year period beginning with the tax year in which the IRS approves its application for reinstatement of tax-exempt status. (**Rev. Proc. 2014-11, §9**).

Streamlined Retroactive Reinstatement Process: An organization that was eligible to file either **Form 990-EZ, Short Form Return Of Organization Exempt from Income Tax**, or **Form 990-N (i.e., e-Postcard)**, for each of the *three consecutive years* that it failed to file and that has *not* previously had its tax-exempt status automatically revoked may use the following "streamlined retroactive reinstatement process:"

- It must submit an application for reinstatement with the appropriate fee no later than 15 months after the *later* of the date of the IRS's revocation letter or the date on which the IRS posted the organization's name on the **Revocation List** (i.e., the list of organizations that have had their tax-exempt statuses revoked under **Code §6033(j)(1)**).

- If approved, the organization will be deemed to have "reasonable cause" for its failures to file Forms 990-EZ or 990-N for three consecutive years, and it will be reinstated *retroactively* to the date of revocation.

- The IRS will *not* impose a penalty under **Code §6652(c)** for failure to file the annual returns for the three consecutive tax years, if the organization files properly completed and executed paper Forms 990-EZ for *all* such tax years. For any year for which the organization was eligible to file a Form 990-N, the organization is *not* required to file a prior year Form 990-N or Form 990-EZ for such year.

Retroactive Reinstatement Process Within 15 Months: An organization that is *not* eligible to use the above "streamlined process" may instead use the following process for retroactive reinstatement of its tax-exempt status:

- It must submit a reinstatement application with the applicable fees no later than 15 months after the *later* of the date of the Revocation Letter or the date on which the IRS posted the organization's name on the Revocation List.

- It also must file properly completed and executed paper Annual Returns for: (a) all tax years in the consecutive three-year period for which the organization was required to, but failed to, file Annual Returns and (b) for any other tax years after such period and before the postmark date for which required returns were due and not filed.

- It must also include: 1) A statement confirming that it has filed those paper returns; 2) A **Reasonable Cause Statement** described in **Rev. Proc. 2014-11, §8.01** (showing "reasonable cause" for its failure to file a required annual return or notice for *at least one* of the three consecutive years).

- If its application is approved, the IRS will *not* impose the penalty under **Code §6652(c)** for the failure to file annual returns for the three consecutive tax years.

Retroactive Reinstatement Process Beyond 15 Months: If it has been more than 15 months from the *later* of the date of the Revocation Letter or the date on which the IRS posted the organization's name on the Revocation List, an organization may apply for retroactive reinstatement of its tax-exempt status "by doing precisely the same steps as those in the within-15-months process" described above, except that the required **Reasonable Cause Statement** is the one described in **Rev. Proc. 2014-11, §8.02** (showing reasonable cause for its failure to file a required annual return or notice for *all* three years that it failed to file)

- If its application is approved, the IRS will *not* impose the penalty under **Code §6652(c)** for the failure to file annual returns for the three consecutive tax years.

Effective Date: Rev. Proc. 2014-11 is effective for reinstatement applications submitted *after* Jan. 2, 2014. Furthermore, transition relief is provided for pending applications and for previously reinstated organizations. (**Rev. Proc. 2014-11, §7**) **(Code §501(c)(3); Tax-Exempt Status)**

☞**IRS Guide on Gambling Activities by Tax-Exempt Entities Available**

The IRS has a useful guide entitled **"Tax-Exempt Organizations and Gaming."** It is intended for tax-exempt entities that seek to raise funds through "casino nights" and other gambling related activities. Most importantly, it advises such entities on avoiding the possible loss of their tax-exempt status especially where there is an excess of such activities (i.e., since these receipts would be considered "unrelated business income"). Also covered in this guide are "excise and payroll tax issues, withholding obligations, helpful recordkeeping tips and the rules for reported winnings." **(Code §501(c)(3);Tax-Exempt Entities)**

Code §512 - Unrelated Business Income Tax:

☞**Charities Soliciting Advertising Income and Impact of UBTI Rules (IRS Issue Snapshot)**

Under **Code §512(a)**, an exempt organization's income from the conduct of a trade or business can nevertheless still be treated as being "substantially related to its exempt purpose" which avoids the entity being subject to the "unrelated business taxable income" (UBTI) rules. For example, when an exempt organization has its own magazine, newsletter, or other publication (e.g., AARP monthly magazine), some or all of its income from selling advertising will *not* be considered UBTI "if the editorial content of the publication is substantially related to the organization's exempt purpose." Royalty income is also excluded from UBTI. However, an issue may arise when an exempt organization contracts with a third-party to publish their magazine or newsletter and then reports the advertising income as royalties. According to this IRS **"Issue Snapshot,"** whether advertising income is properly treated as royalties "is determined from all the facts and circumstances." **(Code §512; UBTI)**

Notes:

ADMINISTRATIVE & PROCEDURAL MATTERS:

Miscellaneous Items:

☞**IRS Provides Relief for Taxpayers Affected by Terrorist Attacks in Israel (IR 2023-188)**

The IRS has announced tax relief for individuals and businesses affected by the terrorist attacks in the State of Israel. Qualifying taxpayers now have until 10/7/24 to file various federal and business tax returns, make tax payments, and perform other time-sensitive tax-related actions that were originally due on or after 10/7/23 and before 10/7/24 (i.e., the "postponement period"). The 10/7/24 deadline applies to 2022 individual, calendar-year corporate, and tax-exempt organization tax returns, certain quarterly estimated income tax payments, certain 2023 individual and business returns and payments, and certain quarterly payroll and excise tax returns, all of which were originally due during the postponement period. In addition, penalties on payroll and excise tax deposits due during the postponement period will be abated, as long as the deposits are made by 10/7/24. Other time-sensitive tax-related actions such as retirement plan contributions and rollovers are postponed as well.

Affected Taxpayers: The following taxpayers fall under this definition:

- Any individual whose principal residence or business entity or sole proprietor whose principal place of business is in Israel, the West Bank or Gaza (i.e., the "covered area").

- Any individual, business or sole proprietor, or estate or trust whose books, records or tax preparer is located in the covered area.

- Anyone killed, injured, or taken hostage due to the terrorist attacks.

- Any individual affiliated with a recognized government or philanthropic organization and who is assisting in the covered area, such as a relief worker. **(Misc.; Tax Relief)**

Comment: The IRS *automatically* identifies taxpayers whose principal residence or principal place of business is located in the "covered area" based on previously filed returns and applies relief. Other eligible taxpayers can obtain this relief by calling the IRS disaster hotline at 866-562-5227. Alternatively, international callers may call 267-941-1000.

Comment: If an affected taxpayer receives a late filing or late payment penalty notice from the IRS for the postponement period, the taxpayer should call the number on the notice to have the penalty abated.

Comment: See **Notice 2023-71** and **Rev. Proc. 2018-58** for additional details.

☞**New Rule for Corporate Reporting of Beneficial Ownership (RIN 1506-AB49)**

Entities doing business in the U.S. will now be required to disclose who owns or controls them, under a final rule on beneficial ownership issued by the Treasury Department. This stipulation stems from a 2019-passed law targeting corruption, tax fraud, money laundering, and terrorist financing. The rule implements the **Corporate Transparency Act (CTA)**, which Congress passed three years ago but was *not* signed into law until early 2021 as part of that year's **National Defense Authorization Act**. The rule will take effect 1/1/24 according to Treasury's **Financial Crimes Enforcement Network (FinCEN)**. The rule will establish a database of beneficial ownership information reported by a corporation or similar legal entity, including the full legal names, dates of birth, and addresses for all individuals who have "substantial control" over the business or who own at least 25% of it.

Comment: This new requirement will affect over 25 million existing business entities and another 3 to 4 million new entities each year. Certain violations may result in the imposition of civil and criminal liability, including civil fines of $500/day, criminal fines of up to $250,000, and up to five (5) years in prison.

Reporting Entities: Any legal entity that is formed through a filing in a secretary of state's office is potentially a "reporting company." This includes but is *not* limited to corporations, LLCs, most partnerships, certain trusts, and other entities. Domestic and foreign entities can be "reporting companies." The CTA, however, provides twenty-three exemptions from the definition of a "reporting company," generally for larger entities or for entities that are already subject to "significant state or federal regulation."

Required Data on "Beneficial Owners" and "Applicants:" Legal names (including d/b/a names), business street address, the jurisdiction where they were formed or registered, and their tax ID number.

Who is a Beneficial Owner? Those who have "substantial control" over a reporting entity or who own or control at least 25% of it. Beneficial owners must provide their legal name, date of birth, residential street address, and the ID number from a state-issued ID, including a picture of the ID.

Potential Reporting Exception: Reporting companies, beneficial owners and applicants may apply to FinCEN for a "FinCEN Identifier," which they *may provide in lieu of their personal details*. But the requirements to obtain a FinCEN Identifier are proposed to be the same as would otherwise be required of beneficial owners.

Time Deadlines for FinCEN Reporting: Once the first wave of regulations takes effect, existing reporting companies will have one year to make their initial report to FinCEN. Entities formed on or after the regulation's effective date will have only 30 days to make their first reports (assuming FinCEN does *not* alter the timelines in its draft regulations). Any changed data will have to be reported within 30 days of the change. Errors in reported data must be corrected within 14 days of discovery.

Comment: The 30-day deadline for new entities has now been extended to 90 days after initial formation.

Access to Reported Data: Federal law enforcement, intelligence agencies and regulators, *including the IRS*, will be able to access the data *without a court order*. State law enforcement will need a court order. **(Misc.; FinCEN)**

Comment: Exactly who may access the data, and how, will be defined in future regulations.

☞Details on "Beneficial Reporting" Requirement for 2024

New "beneficial reporting" rules will be going into effect for 2024 and will impact many smaller businesses. They are a result of the **Corporate Transparency Act of 2020** which took effect as of 1/1/2021. Final regs which governed their operation were issued by the **Financial Crimes Enforcement Network (FinCEN)** on 9/29/22 and apply to tax years beginning 11/2024 and thereafter. The intent of these regs is "to protect the U.S. financial systems from criminal use by providing information to national security, intelligence and law enforcement agencies to help prevent the use of shell companies to launder money or hide assets." "Shell companies" are usually privately-held corporations, LLCs or other types of companies with no physical presence and little or no economic value. Their main objective is to carry out financial transactions while simultaneously shielding their owners' involvement or identity. At the present time, the only information available to law enforcement agencies concerning who exactly owns and operates these businesses is limited to what was filed when the entity was first formed.

> **<u>Comment</u>:** Clients potentially impacted by these new rules should be alerted before their start for the 2024 tax year and advised as to what additional information will now need to be provided. And, any new entities being formed after 2023 will also be required to supply more detailed background as to the owners who will be benefitting from their existence.

<u>Who Must File</u>: Both domestic and foreign reporting companies will be subject to these reporting requirements. Specifically, a "domestic reporting company" is any corporation, LLC, or other entity created by filing a document with the Secretary of State (or, other equivalent agency). Conversely, since sole proprietorships, trusts, and general partnerships do *not* require the filing of a formal document, they are generally *not* considered to be a "reporting company" under these new rules. A "foreign reporting company" is any corporation, LLC, or similar entity that registers to do business in the U.S. by filing a document with the Secretary of State (or, other equivalent agency).

> **<u>Comment</u>:** Since most limited partnerships, LLPs or LLLPs come into existence with the filing of a document with the Secretary of State, they would also be considered "reporting companies."

<u>Statutory Exemptions</u>: There are currently 23 separate exemptions which exclude certain entities from having to comply with these reporting requirements. Most of the exemptions deal with financial institutions, insurance companies, securities brokers, along with other types of entities that are already required to report ownership information to a governmental authority or agency. Another major exception to the having to comply with the reporting requirements pertains to "large operating companies." These entities are defined as those (1) having more than 20 full-time U.S. employees; (2) an "operating presence" at a physical office located in the U.S.; and (3) more than $5,000,000 U.S. sourced gross receipts reported on its most recent tax return.

> **<u>Comment</u>:** Presumably, companies that meet all three of these "conjunctive tests" are less likely to be a "shell company" merely seeking to hide the identity of its owners who ultimately are benefitting from income being otherwise hidden from the IRS and other federal agencies.

<u>Filing Deadlines</u>: Initial reporting for existing companies (and, those formed *before* 1/1/2024) will be 1/1/2025. For entities formed (or, registered) *after* 2023, the reporting requirement will be within 30 days after formation.

<u>Updated Reports</u>: Where there have been changes to previously reported data (e.g., change in the beneficial ownership of the entity), the entity will have 30 days to inform the government of such changes. Another example might be where the entity now qualifies for one of the 23 statutory exemptions and now they would have 30 days to inform the government that they no longer have a reporting requirement. Any corrections to reports already filed would also have to be done within 30 days once the mistake is uncovered (or, the person responsible for filing the report should have been aware of the change or mistake).

> **<u>Comment</u>:** FinCEN is developing a "secure electronic filing system" that should be up and running for receiving these reports by 1/1/2024.

<u>Required Information</u>: "Beneficial ownership information" (BOI) must be provided for the reporting company's "beneficial owners," as well as certain "company applicants." BOI information includes the owner's full legal name, date of birth, street address and unique ID number. This could include an unexpired U.S. passport, state driver's license, or other photo-identification cared issued by the state or local government. If an individual does *not* have any of these items, then an unexpired foreign passport will be accepted. An image of the document showing the unique ID number must also be included with the report. Similar information about the reporting entity must also be provided and would include the company's legal name, DBA, street address, jurisdiction where it was formed or registered, and tax ID.

FinCEN Identifier Alternative: Individuals and reporting companies can instead request a FinCEN identifier (FinCEN ID) to be used in placed of the detailed information listed above. This alternative might be useful where the beneficial owner would rather supply this personal information directly to FinCEN instead on indirectly through the reporting company. Again, any changes in this required information must be supplied within 30 days.

Beneficial Owner Defined: Two groups of individuals can fall under the definition of a "beneficial owner" of a "reporting company" for purposes of these reporting rules as follows: (1) Any individual who directly or indirectly exercises "substantial control" over the reporting company; or (2) Any individual who directly or indirectly owns or controls 25% or more of the reporting company's "ownership interests."

Substantial Control Defined: "Substantial control" is defined as having substantial influence over important decisions made by the reporting company. It should be noted that these individuals need *not* have any actual ownership in the company. And, the company's senior officers are *automatically* deemed to have "substantial control," as are any individuals with the authority to appoint or remove any senior officer or majority of the board of directors. "Senior officers" would include the company's president, CFO, general counsel , CEO, COO, and any other officer who performs a similar function, regardless of their official title.

Ownership Interest: The term is broadly defined and would include any direct (or, indirect) equity, stock, or similar interest; any capital or profits interest; any convertible interest (including debt), along with a host of other potential ownership interests.

Exceptions to Beneficial Owner Definition: There are five exceptions to the definition of a "beneficial owner" as follows:

1) A minor child when the reporting company already includes the information for the child's parent or guardian;

2) A nominee, intermediary, custodial, or agent of another individual;

3) A reporting company's employee who is not a senior officer and is acting solely in their capacity as an employee;

4) An individual having only a future interest in the reporting company through a future inheritance; and

5) A creditor of the reporting company

Company Applicants: The "company applicant" is the individual who directly files the document that creates or registers the reporting company. As such, "company applicants" must provide the same information that is required of the "beneficial owners," but only if the entity is formed *after* 2023.

> **Comment:** FinCEN acknowledges that obtaining the personal information for company applicants of a reporting company that was formed years ago may be difficult, if not impossible, in some cases. As a result, reporting companies formed *before* 2024 do *not* have to supply BOI for their "company applicants."

Comment: Keep in mind, though, if you assist clients with "entity formation engagements" *after* 2023, there might be an obligation to supply your BOI to FinCEN (i.e., as a "company applicant"). If that is the case, especially if you assisted multiple clients, obtaining a FinCEN ID would be recommended. So, for instance, law firms and attorneys that assist in setting up new companies or entities would clearly fall under this requirement.

Penalties for Reporting Violations: Penalties for noncompliance are significant. Even though "reporting companies" are responsible for filing these BOI reports, beneficial owners (including senior officers), along with "company applicants," can be held liable for *both* civil and criminal penalties for failure to provide (or, for providing false) required information. "Wilful failures" are subject to a $500/day penalty and up to two years of imprisonment. In addition, the fine for knowingly disclosing or using BOI information without authorization is also $500/day, up to $250,000 in total, along with a possible 5-year jail term. **(Misc.; Beneficial Companies)**

Comment: A "safe harbor" to avoid penalties is available if previously incorrect report information is ratified within 90 days after the original report was submitted.

Comment: Although this reporting requirement will not go into effect for over a year from now, many of our clients will be affected. Therefore, some communication with those impacted should commence as we enter into the 2024 tax year. Also, we need to realize that some of us will be labeled as "company applicants" and will have to supply personal information. If that is the case, it might be advisable to obtain a FinCEN ID to be used by the "reporting company."

☞**IRS Proposes More Time for New Companies on Reporting "Beneficial Ownership" (RIN 1506-AB62)**

The IRS has proposed giving newly-formed companies more time to report their "beneficial ownership information" under new rules that take effect next year (i.e., as of 1/1/2025). Companies created or registered in 2024 would now have 90 days (i.e., from the initial date of their formation) to report their "beneficial ownership" information. Existing rules for new entities would have only given them 30 days to do so.

Comment: As previously mentioned, these new "beneficial ownership" reporting requirements will now require tens of millions of companies to report the names, addresses, and other information about their "beneficial owners" (i.e., anyone who owns at least 25% of the company or who "exerts significant authority" over the entity in question) to the Treasury Department's **Financial Crimes Enforcement Network(FinCEN)**. The disclosure is intended to assist law enforcement agencies "track and crack down on shell companies that fund terrorism, drug trafficking, and other global criminal activity."

Comment: Companies created *before* the new reporting requirements take effect (i.e., as of 1/1/2024) will have a year to file their initial disclosure reports (i.e., such reporting would be due 1/1/2025).

☞**FinCEN Releases "Beneficial Ownership Information Reporting" Compliance Guide**

The Financial Crimes Enforcement Network (FinCEN) has published a **Small Entity Compliance Guide** to help small businesses satisfy the new "beneficial ownership information (BOI) reporting rules." The **Corporate Transparency Act** **(CTA)** established uniform BOI reporting requirements for certain corporations, limited liability companies, and other similar entities created, or registered to do business, in the U.S. FinCEN has issued final regulations implementing the CTA's BOI reporting requirements in September 2022, which go into effect on 1/1/24. The new **Small Entity Compliance Guide** is intended to help businesses determine if they are required to report their BOI to FinCEN under these final rules.

The guide addresses some core issues, including each of the BOI reporting rule's provisions, answers to key questions, and interactive checklists, infographics, and other tools aimed at helping businesses comply. **(Misc.; Beneficial Ownership)**

Comment: FinCEN also announced that guidance on how to submit BOI reports will be provided soon. But the upcoming tax busy season would be a good time to identify those clients/entities that will be required to submit these reports to FinCEN by the end of 2024.

☞**2023 Filing Season "Massive Improvement" Over Last Year (IR-2023-119)**

This report filed by the Taxpayer Advocate Office to Congress analyzes the IRS's effectiveness in processing original returns, amended returns, taxpayer correspondence and answering taxpayer telephone calls.

Comment: Thanks to **Inflation Reduction Act** resources, the IRS "delivered dramatically improved service" during this most recent filing season. The IRS achieved an 87% level of service. As discussed below, through the end of filing season, the IRS answered 3 million more calls, cut phone wait times to three minutes from 28 minutes, served 140,000 more taxpayers in-person, digitized 80 times more returns than in 2022 through the adoption of new scanning technology, cleared the backlog of unprocessed 2022 individual tax returns with no errors, launched two new digital tools, and enabled a new direct-deposit refund option for taxpayers with amended returns.

"What a difference a year makes!" Taxpayer Advocate Collins wrote in her preface to the report. Reflecting on the challenges taxpayers experienced in recent filing seasons due to the COVID-19 pandemic, she said, "In submitting this report, I'm finally able to deliver some good news: The taxpayer experience vastly improved during the 2023 filing season. The IRS caught up in processing paper-filed original **Forms 1040** and various business returns; refunds were generally issued quickly; and taxpayers calling the IRS were much more likely to get through – and with substantially shorter wait times. Overall, the difference between the 2022 filing season and the 2023 filing season was like night and day."

Despite these improvements, the report says the IRS is still behind in processing amended tax returns and taxpayer correspondence. Typically, employees in the IRS's Accounts Management function perform two roles – they answer telephone calls, and they process taxpayer correspondence, amended returns and other cases. The report says the IRS was much more effective in answering taxpayer calls this year, "but [that] could only be accomplished by prioritizing the phones over other IRS operations, and it resulted in greater delays in the processing of paper correspondence."

Processing of Original Returns: The IRS reduced its backlog of unprocessed paper-filed original tax returns from 13.3 million at the end of the 2022 filing season to 2.6 million at the end of the 2023 filing season. That represents a reduction of 80% and marks a return to pre-pandemic levels.

Processing of Amended Returns: In contrast to the 80% reduction in the backlog of paper-filed original tax returns, the inventory of amended returns was 3.6 million in April 2022 and 3.4 million in April 2023, a reduction of only six percent between the two periods.

Processing of Taxpayer Correspondence and Other Accounts Management (Am) Cases: In addition to answering telephone calls and processing amended tax returns, AM employees process taxpayer responses to IRS notices and many types of taxpayer requests, such as applications for Employer Identification Numbers, a high percentage of Identity Theft Victim Assistance cases, and tax return preparer authorizations. The IRS "has *not* made notable progress in reducing its paper AM inventories over the past year." The inventory is just six percent lower than at the same time last year. In April, it was taking the IRS 130 days to process its adjustments cases. That "represents a substantial improvement" from the 214 days it was taking last year, but it is "still well above the IRS's standard processing time of 45 days."

Comment: Substantially all Earned Income Tax Credit audits are conducted by mail. During 2022, correspondence audits resulted in a 41.6% no-response rate, only a 20.8% agreement rate and a 20.4% default rate. As a result, during FY 2024, TAS "plans to continue working on cross-functional teams with other IRS business units to improve the correspondence examination process."

IRS "First-time Abatement:" Under existing procedures, the IRS will provide a "first-time abatement (FTA)" of penalties for failure to file, failure to pay and failure to deposit required tax if a taxpayer is otherwise compliant and has *not* used FTA within the prior *three* years. However, FTA is generally provided "only if a taxpayer requests FTA or reasonable cause relief." In 2021, the IRS granted FTA to about 200,000 taxpayers requesting relief from these penalties. Nevertheless, there were about 4.3 million taxpayers otherwise eligible for relief from these penalties who did *not* receive it. The result was that a "relatively small percentage of sophisticated taxpayers or taxpayers who paid for professional assistance received penalty abatements just for asking while the overwhelming majority of taxpayers who do not know the IRS is willing to abate these penalties did not." Relatedly, TAS believes taxpayers who qualify for "reasonable cause" penalty relief should receive it and *not* be forced to use their once-in-three-years FTA waiver.

Comment: As a result, during FY 2024, TAS plans to continue working with the IRS to ensure that similarly situated taxpayers receive equitable treatment in the abatement of these penalties. **(Misc.; NTA Midyear Report)**

☞**IRS 2023 Dirty Dozen Campaign Begins with ERC Claims (IR 2023-49)**

For the start of the Service's annual Dirty Dozen list of tax scams, the IRS has chosen to emphasize Employee Retention Credits. This stems from the blatant attempts by promoters to con ineligible businesses to claim the credit and includes schemes from promoters who have been using radio ads and the internet promising refunds involving ERCs. These promotions can be based on inaccurate information related to eligibility for and computation of the credit. The **IRS Office of Professional Responsibility** sent a special bulletin (**OPR Issue 2023-02**) to tax professionals on 3/7/23 outlining core responsibilities for ERC claims under **Circular 230**. The IRS continues to step up enforcement action involving these ERC claims and employers considering filing for these claims, reminding them that they are ultimately responsible for the accuracy of the information on their tax return. **(Misc.; ERC)**

Comment: According to the IRS, the "**Dirty Dozen**" is an annual list put out by the Service of the 12 scams and schemes that put taxpayers and the tax professional community at risk of losing money, personal data and more. Some items on the list are new, and some make a return visit. While the list is *not* a legal document or a formal listing of agency enforcement priorities, it is intended to alert taxpayers, businesses and tax preparers about scams at large.

Comment: **IR-2023-67** also contains a warning for taxpayers to beware of promoters peddling bogus tax schemes aimed at reducing taxes or avoiding them altogether. According to the IRS, "These schemes can take many shapes, ranging from abusive deals involving syndicated conservation easements and micro-captive insurance arrangements. They can also involve an international component, such as hiding cash and digital assets offshore or using Maltese foreign individual retirement accounts or foreign captive insurance." More information regarding these schemes can be found in **IR-2023-67**.

☞**IRS Shifting Compliance Focus to High-income Individuals & Larger Businesses**

The Service has announced that "it will shift its attention to wealthy from working-class taxpayers." The IRS stated that key changes are coming which would "reduce the burden on average taxpayers while using Artificial Intelligence" and thereby "improve technology to identify sophisticated schemes to avoid taxes."

<u>Inflation Reduction Act</u>: Because of the new funding for the IRS contained in the **Inflation Reduction Act** and following "a top-to-bottom review of enforcement efforts," the Service announced the start of "a sweeping, historic effort to restore fairness in tax compliance by shifting more attention onto high-income earners, partnerships, large corporations and promoters abusing the nation's tax laws." This is especially true in light of the extremely low audit rates for these taxpayers during the past decade. The changes "will be driven with the help of improved technology as well as Artificial Intelligence that will help IRS compliance teams better detect tax cheating, identify emerging compliance threats and improve case selection tools to avoid burdening taxpayers with needless 'no-change' audits."
As part of the effort, the IRS will also ensure audit rates do *not* increase for those earning less than $400,000 a year "as well as adding new fairness safeguards for those individuals claiming the Earned Income Tax Credit." Audit rates of those receiving the EITC "remain at high levels in recent years while rates dropped precipitously for those with higher income, partnerships and others with more complex tax situations."

> **<u>Comment</u>:** The reason that the EITC is so heavily audited by the IRS is that over 31% (based on most recent IRS statistics) of these credits are paid out in error, either due to fraud or just incorrectly prepared returns.

"This new compliance push makes good on the promise of the **Inflation Reduction Act** to ensure the IRS holds our wealthiest filers accountable to pay the full amount of what they owe," said IRS Commissioner Danny Werfel. "The years of underfunding that predated the **Inflation Reduction Act** led to the lowest audit rate of wealthy filers in our history. I am committed to reversing this trend, making sure that new funding will mean more effective compliance efforts on the wealthy, while middle- and low-income filers will continue to see no change in historically low pre-IRA audit rates for years to come."

"There is a sea change taking place at the IRS in every aspect of our operations. Anchored by a deep respect for taxpayer rights, the IRS deploying new resources towards cutting-edge technology to improve our visibility on where the wealthy shield their income and focus staff attention on the areas of greatest abuse. We will increase our compliance efforts on those posing the greatest risk to our nation's tax system, whether it's the wealthy looking to dodge paying their fair share or promoters aggressively peddling abusive schemes. These steps are critical for the future of the nation's tax system."

Key elements of this new IRS effort include:

- Major expansion in high-income/high wealth and partnership compliance work: As part of the **<u>High Wealth, High Balance Due Taxpayer Field Initiative</u>**, the IRS "will intensify work" on taxpayers with total positive income above $1 million that have more than $250,000 in recognized tax debt. Building off earlier successes that collected $38 million from more than 175 high-income earners, the IRS will have dozens of Revenue Officers focusing on these high-end collection cases in FY 2024. The IRS is working to expand this effort, contacting about 1,600 taxpayers in this category that owe hundreds of millions of dollars in taxes.

In 2021, the IRS launched the first stage of its **<u>Large Partnership Compliance (LPC)</u>** program with examinations of some of the largest and most complex partnership returns in the filing population. The IRS is now expanding the LPC program to additional large partnerships. With the help of AI, the selection of these returns "is the result of groundbreaking collaboration among experts in data science and tax enforcement, who have been working side-by-side to apply cutting-edge machine learning technology to identify potential compliance risk in the areas of partnership tax, general income tax and accounting, and international tax in a taxpayer segment that historically has been subject to limited examination coverage." In the near future, the IRS will open examinations of 75 of the largest partnerships in the U.S. that represent a cross section of industries including hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms and other industries. On average, these partnerships each have more than $10 billion in assets.

- **Priority areas for targeted compliance work in FY 2024:** The IRS has launched "numerous compliance efforts" to address serious issues being seen. Some of these, like "abusive micro-captive insurance arrangements" and "syndicated conservation easement abuses," have received extensive public attention. But much more work continues behind the scenes on other issues.

Among some of the additional priority areas the IRS will be focused on that will touch the wealthy evaders include:

- **Expanded Work on Digital Assets:** The IRS continues to expand efforts involving digital assets, including work through the "**John Doe summons effort**" and last month's release of proposed regulations covering broker reporting. The **IRS Virtual Currency Compliance Campaign** will continue in the months ahead after an initial review showed the "potential for a 75% non-compliance rate" among taxpayers identified through record production from digital currency exchanges.

- **More Scrutiny on FBAR Violations:** High-income taxpayers from all segments continue to utilize foreign bank accounts to avoid disclosure and related taxes. A U.S. person with a financial interest over a foreign financial account is required to file a **Report of Foreign Bank and Financial Accounts (FBAR)** if the aggregate value of all foreign financial accounts is *more than $10,000 at any time*. IRS analysis of multi-year filing patterns has identified hundreds of possible FBAR non-filers with account balances that average over $1.4 million. The IRS plans to audit the "most egregious potential non-filer FBAR cases" in Fiscal Year 2024.

- **Labor Brokers:** The IRS has seen instances where construction contractors are making **Form 1099MISC/1099NEC** payments to an apparent subcontractor, but the subcontractor is a "shell" company that has no legitimate business relationship with the contractor. Monies paid to shell companies are exchanged at **Money Service Businesses** or flowed through accounts in the name of the shell company and returned to the original contractor. The IRS will be expanding attention in this area with both civil audits and criminal investigations. The scheme has already been seen in Texas and Florida. Work in this area is critical to improve compliance, and it will "also help level the playing field for contractors playing by the rules as well as ensuring proper employment tax withholding for vulnerable workers."

- **Improved Equity in Audits:** The IRS continues to focus on making improvements in audits involving Earned Income Tax Credits and will be implementing changes for the next filing season.

- **Emerging Scam Issues:** The IRS will continue its aggressive work warning consumers about emerging scams and schemes. Building off efforts like the **Dirty Dozen**, the IRS plans to warn taxpayers about quickly emerging scams. As the IRS has seen through the years, scammers frequently adjust or change their tactics to tag onto recent tax law changes or other events that can confuse taxpayers into trying to claim refunds worth thousands of dollars. This effort can touch on issues like sick leave and family leave as well as false fuel tax credit claims.

- **Protection Against Identity Theft:** The IRS will continue the ground-breaking efforts of the **Security Summit** initiative, a joint effort between the federal government, state tax agencies and the nation's software and tax professional communities. Since 2015, the private-public sector coalition has worked together to build internal defenses and share information to protect against identity thieves trying to steal tax refunds. A key part of the Security Summit initiative has been focused on raising taxpayer and tax professional awareness on how to protect themselves and their tax data from identity theft. **(Misc.; IRS Initiatives)**

☞**IRS Decides to Terminate Most Unannounced Revenue Officer Visits (IR 2023-133)**

The IRS has announced that effective immediately, unannounced visits to taxpayers by agency revenue officers will end "except in a few unique circumstances." In place of the unannounced visits, revenue officers will make contact with taxpayers through an appointment letter (i.e., **Letter 725-B**) and schedule a follow-up meeting. Due to the "increased security concerns" for both taxpayers and IRS employees, these visits "will be curtailed except in extremely limited situations." Scam artists have appeared at taxpayers' doors posing as IRS agents creating confusion not only for taxpayers but local law enforcement. The IRS will be updating its website and internal guidance to reflect the changes. With 10-year funding available from the **Inflation Reduction Act**, the IRS is tasked with improving taxpayer service, adding fairness to tax compliance efforts, and modernizing technology to better serve taxpayers and tax professionals. **(Misc.; IRS Audits)**

☞**IRS Expands Use of Chatbots to Help Answer Questions on Key Notices (IR-2023-178)**

The Service has announced the availability of "expanded chatbot technology" to help quickly answer basic questions for people receiving notices about possibly underreporting their taxes. The new chatbot feature will assist taxpayers who receive notices **CP2000**, **CP2501** and **CP3219A**. These mailings inform taxpayers if the tax information the IRS received from third parties does *not* match the information they provided themselves to the IRS.

> **Comment:** This technology expansion is supported through the **Inflation Reduction Act** funding intended "to transform the IRS and improve services to help taxpayers."

"Through our transformation efforts, we are working to expand technologies to help taxpayers and tax professionals interact with us in the ways they prefer, including expanded digital, phone and in-person assistance options," said IRS Commissioner Danny Werfel. "We understand receiving a notice from the IRS can be concerning, and people frequently have questions. The use of chatbots in call centers has emerged as an effective practice in both the private and public sectors, making it easier for people to quickly get basic information to resolve their issues and avoid wait times on the phone. Deploying chatbots at the IRS call center helps taxpayers get their issues resolved quicker, and it helps free up valuable phone resources for other taxpayers with questions on more complex issues."

Rollout of this chatbot builds on prior IRS successes using the technology to help improve taxpayer service. Since January 2022, IRS voice and chatbots, both in English and Spanish, helped more than 13 million taxpayers avoid wait times by resolving their tax issues, including setting up roughly $151 million in payment agreements.

The chatbot simulates human interaction with taxpayers through a web or mobile app on a computer or mobile screen by responding to questions or requests in a chat feature. Also, at the end of the conversation, taxpayers can press the "representative" button to speak to a live assistor.

The new IRS chatbot is available to help taxpayers with questions such as:

- What to do if they received a notice

- What to do if they need more time to respond to a notice

- How to find out if the IRS received their response

Comment: The IRS plans to continue additional bot technology features in the future to assist taxpayers with more complex issues. **(Misc.; IRS Chatbot)**

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A great way to stay up to date on tax information year-round is with IRS verified social media accounts and e-news services. Tax professionals can get tips, guidance and the latest tax law news delivered to their social feed or inbox. And, you will get this updated information just as quickly as CCH, Thompson Reuters or other third parties which charge a subscription base. As mentioned below regarding the new tax video on **Form 1099-K**, there are a number of items that are suitable for sending out to your clients as well. Click on the IRS **website** link to chose those specific items which are of interest and best apply to your practice. **(Misc.; IRS News)**

☞**New IRS Video for Potential Form 1099-K Recipients**

Individuals who sell items or provide a service and get paid by a third-party payment card or through a payment app may get a **Form 1099-K** reporting these transactions to the IRS. In response, the Service has now come out with a new video **"Tax Tip"** entitled **"Are you making extra cash selling stuff or providing a service?"** which provides taxpayers with guidance on how to report this type of income or correct erroneous **Form 1099-Ks**.

Comment: This might be an excellent item to give to those clients utilizing third-party payment processors for goods that they are selling, or services that they are providing. And, as of now, the threshold for **Form 1099- K** reporting remains at just $600 (regardless of the number of transactions), though Congress might intercede and raise this limit *retroactively* for the 2023 tax year.

☞**IRS Updates Tax Gap Projections for 2020, 2021 with Projected Annual Gap Increasing to $688 Billion (IR-2023-187)**

The IRS has released new "tax gap projections" for tax years 2020 and 2021 showing the projected gross tax gap increased to $688 billion in tax year 2021 which represents a "significant jump from previous estimates." The new estimate reflects a rise of more than $192 billion from the prior estimates for tax years 2014-2016 and a rise of $138 billion from the revised projections for tax years 2017-2019. This also marks the first year tax gap projections have been provided for *single* tax years and also marks the beginning of tax gap updates on an *annual* basis.

Tax Gap Defined: The $688 gross tax gap is the difference between estimated 'true' tax liability for a given period and the amount of tax that is actually paid on time. The gross tax gap covers three key areas - nonfiling of taxes, underreporting of taxes (i.e., due to omission of income or claiming erroneous deductions) and underpayment of taxes. Nevertheless, the IRS concedes that the tax gap estimates and projections cannot fully account for all types of noncompliance. In addition, the projections are based largely upon the compliance behavior estimated from the most recent set of completed audits (i.e., from tax years 2014-2016). That estimated compliance behavior is then projected forward to taxpayers in tax years 2020 and 2021.

IRS Enforcement Efforts: Late payments and IRS enforcement efforts are projected to generate an additional $63 billion on tax year 2021 returns, resulting in a projected net tax gap of $625 billion. Between tax years 2014-2016 and tax year 2021, the estimated tax liability increased by about 38 percent, roughly the same increase as the gross and net tax gaps. According to the IRS, much of these increases in tax liability and the tax gap "can be attributed to economic growth."

Voluntary Compliance Rate: The tax year 2020 and 2021 tax gap projections translate to about 85% of taxes paid voluntarily and on time, which is in line with recent levels. After IRS compliance efforts are factored in, the projected share of taxes eventually paid is 86.3% for tax year 2021, down slightly from the 87.0% for tax years 2014-2016. But this drop in compliance does *not* factor in "any changes in compliance behavior." Rather, it is due to changes in the types of income and how that income is reported to the IRS.

Tax Gap Components: The gross tax gap comprises three components as follows:

- Nonfiling, which means tax *not* paid on time by those who do *not* file on time. This amounted to $77 billion in tax year 2021, up from $41 billion in tax years 2017-2019.

- Underreporting, which reflects tax understated on timely filed returns. This amounted to $542 billion in tax year 2021, up from $445 billion in tax years 2017-2019.

- Underpayment, or tax that was reported on time, but *not* paid on time. This amounted to $68 billion in tax year 2021, up from $64 billion in tax years 2017-2019.

IRS "Paper Trail:" Tax gap studies through the years "have consistently demonstrated that third-party reporting of income significantly raises voluntary compliance with the tax laws." And voluntary compliance rises even higher when income payments are also subject to withholding. **(Misc.; Tax Gap)**

> **Comment:** The IRS also has a number of other "taxpayer service programs aimed at supporting accurate tax filing and helping address the tax gap." These range from working with businesses and partner groups to a variety of education and outreach efforts. Moreover, a one-percentage-point increase in voluntary compliance would bring in about $46 billion in additional tax receipts.

☞IRS Penalty Amounts Increase for 2024

Failure to File Tax Return:

For 2024, the minimum penalty under **Code §6651(a)** for failure to timely file a tax return is $510 ($485 in 2023).

Failure to File Partnership Return:

For 2024, the dollar amount used to determine the amount of the penalty under **Code §6698(b)(1)** is $245 ($235 in 2023).

> **Comment:** Of course, **Rev. Proc. 84-35** is still available to waive this penalty given certain requirements are met. But this penalty is "per partner" and "per month" until the return is actually filed (i.e., 12-month maximum for a given tax year).

Failure to File S Corporation Return:

The dollar amount used to determine the amount of the penalty under **Code §6699(b)(1)** is $245 ($235 in 2023).

> **Comment:** The assertion of the "first-time abatement" waiver can serve to avoid this penalty if certain conditions are met.

☞**Dramatic Increase for Form 2210 Underpayments**

The IRS continues to impose more estimated tax penalties on individuals, according to recent statistics that show between 2017 and 2022 a 24% increase in the number of these fines due to failure of making the necessary deposits of tax, or simply from errors on quarterly payments and/or for those taxpayers who have too little federal income tax withheld. And this is in addition to a 42% hike in the number of these fines between 2012 and 2017. **(Misc.; Form 2210)**

☞**IRS Issues Guidance on Form 1099-K for 2023 Tax Year (Tax Tip 2023-37)**

> **Comment:** After receiving an IRS reprieve for the 2022 tax year, **Form 1099-K** will be back in full force for the current tax year. So, it makes sense to get the word out to our clients on how to deal with the reporting of such income. And, if the 1099-K has been issued erroneously, how to get that fixed.

Form 1099-K, Payment Card and Third-Party Network Transactions, is used to report certain payment transactions which the IRS is reminding taxpayers to include in their gross income when filing their 2023 **Form 1040**.

This could include payment for various business transactions, including income from:

- A business the taxpayer owns
- Self-employment
- Activities in the gig economy
- The sale of personal items and assets

Money received as a gift or for reimbursement, however, does *not* require a 1099-K. Taxpayers can minimize the chance of an error in such cases by informing friends or family members to correctly designate that type of payment as a "non-business-related transaction." The taxpayer should also make a note of what the payment was for and who sent it. If ever contested by the IRS, good recordkeeping will be key in resolving any audit issues. And if the information is incorrect on the **Form 1099-K**, taxpayers should contact the issuer immediately. The issuing organization's name will appear in the upper left corner on the form. In addition, taxpayers should keep a copy of all correspondence with the issuer for their records.

If a taxpayer receives a **Form 1099-K** in error and the taxpayer *cannot* obtain a corrected Form 1099-K, the taxpayers should follow the Service's updated guidance contained in their publication entitled **Understanding Your Form 1099-K**.

> **Comment:** Also, it might be advisable to include **Form 8082, Notice of Inconsistent Treatment** when filing their return.

As far as the **Form 1099-K** reporting threshold for the 2023 tax year, the **American Rescue Plan of 2021** changed the reporting threshold requirement for payment apps, also known as "third-party settlement organizations." After a one-year delay, the new **Form 1099-K** reporting threshold will start in 2023. The *old* threshold was $20,000 and 200 transactions per year and this continues to apply to tax year 2022 and prior years. Now, the *new* threshold will apply at $600 or more (regardless of the number of transactions). **(Misc.; Form 1099-K)**

> **Comment:** This dramatically lower threshold means that clients may receive a **Form 1099-K** who have *not* received one in the past. Therefore, it makes a great deal of sense to get the word out now in the middle of the 2023 tax year and not wait until yearend or next busy season to confront

the confusion this might generate during the height of next year's busy season.

Comment: The IRS has also updated its list of **FAQs** which provide additional tips and guidance on this third-party reporting requirement.

☞IRS Updates Form 1099-K Website

Although there is a good chance that Congress will act to increase the filing threshold from $600 for the new **Form 1099-K** reporting requirement for the 2023 tax year, this updated IRS **website** is well worth looking at as it contains valuable compliance information regardless of whatever the filing threshold ultimately set at. The page separates information for *personal* items sold versus selling goods, renting property and providing services. It also includes important information about: (1) What should *not* be reported on **Form 1099-K**; (2) What to do if the information on the form is incorrect; and (3) Who gets the form. **(Misc.; Form 1099-K)**

Comment: Recently proposed legislation introduced by the Republicans in the House at this point in time would raise the threshold up to $10,000 (i.e., instead of the current $600 amount). But its passage (along with the continuation of 100% bonus depreciation, tax credits for R&D costs instead of 5-year amortization and restoration of 50% of "adjusted taxable income" before interest, taxes, depreciation and amortization) depend on some concessions for increased child care credits (up from $2,000 at the current time) and greater deductibility of child care costs which the Democrats are demanding in return.

☞Service Releases Draft of Form 1099-K

Although some minor changes might be made to the final version of this form, it is worth noting the types of information that the IRS will be receiving via this new "paper trail." Especially for those individuals with side gigs and who, perhaps, have not been concerned regarding payments of estimated tax for their net profits, this could be a game changer. One of the key issues, however, is where personal items are sold for instance on Craig's list and whose basis (which would most probably be the original cost) results in an overall net loss being realized. Of course, personal losses on such sales are nondeductible, but the Service (if a third-party payment processing firm like PayPal is used) would still receive just a record of the gross proceeds (and, would *not* have any clue as to what the basis of the property sold would have been). Keep in mind that if the gross proceeds do *not* exceed $600 for the year (regardless of the number of transactions), then no **Form 1099-K** will be issued. And, if simply a personal transfer of money is involved (e.g., a group of friends goes out to dinner and one person pays the bill with the others forwarding what they owe later on), then outfits like Zelle will *not* be reporting anything. **(Misc.; Form 1099-K)**

The following is a summary of what the draft version of **Form 1099-K** includes:

- TINs of both the third-party payee and recipient of the funds

- Gross amount of payment card/third party network transactions

- "Card not present" transactions

- Merchant category code

- Number of payment transactions

- Federal income tax withheld (if any)

- Breakdown of transactions by payment cards v. third-party network

- Breakdown of gross amounts paid to recipient by month

☞**IRS Reminds Gig Workers of Tax Filing Responsibilities** (**Tax Tip 2022-97**)

The IRS is reminding taxpayers who take up "gig work" such as driving a car for booked rides, selling goods online, renting out property, or providing other on-demand work on a part-time or full-time basis, often through a digital platform like an app or website, that income derived from such activities is taxable and must be reported on the worker's tax return. The Service has listed, for example, "some things gig workers should know to stay on top of their tax responsibilities:"

- **Gig work is taxable:** Earnings from gig economy work is taxable, regardless of whether an individual receives information returns. The reporting **requirement** for issuance of **Form 1099-K** changed for payments received in 2022 to totals exceeding $600, regardless of the total number of transactions (i.e., formerly, the thresholds were $20,000 or 200 transactions). As a result, many more gig workers will now receive an information return. This is true even if the work is full-time or part-time. Furthermore, gig workers may be required to make quarterly **estimated tax payments** since, as self-employed taxpayers they are required to pay all their Social Security and Medicare taxes on their income from the gig activity.

- **Proper worker classification:** While providing gig economy services, it is important that the taxpayer is correctly classified. This means the business, or the platform, must determine whether the individual providing the services is an employee or independent contractor. Taxpayers can use the worker classification page on **IRS.gov** to see how they should be classified. Independent contractors may be able to deduct business expenses (e.g., on **Schedule C**), depending on tax limits and rules. It is important for taxpayers to keep records to substantiate their business expens

- **Estimated tax payments:** An employer typically withholds income taxes from their employees' pay to help cover income taxes their employees owe. Gig economy workers who are *not* considered to be employees have two ways to cover their income taxes: (1) Submit a *new* **Form W-4** to their employer to have more income taxes withheld from their paycheck if they have another job as an employee and (2) Make quarterly estimated tax payments to help pay their income taxes throughout the year, including self-employment tax. **(Code §3121(d)(2); Gig Workers)**

> **Comment:** The **Gig Economy Tax Center** on IRS.gov answers questions and helps gig economy taxpayers understand their tax responsibilities.
>
> **Comment:** More detailed information on this issue of independent contractor v. employee with regard to gig workers can be found in the following publications:
>
> **IRS Pub. 5369, Gig Economy and your taxes: things to know**
>
> **IRS Pub. 1779, Independent Contractor or Employee**
>
> **Is My Residential Rental Income Taxable and/or Are My Expenses Deductible?**

☞**TIGTA Audit Reveals Tremendous Under-Reporting by "Gig Economy" (Audit Report No. 2019-30-016)**

This recent TIGTA audit was undertaken to evaluate the self-employment tax compliance of taxpayers who earn income in the "gig economy." The study concluded that "significant income under-reporting" had occurred, as well as problems within the IRS' **Automated Underreporter (AUR) Program**. As described in the audit, "the gig economy (i.e., "sharing economy") is comprised of "on-line platform companies" such as Uber, Lyft, Etsy, Handy, and TaskRabbit." Auditors reviewed cases in the AUR program for taxpayers who work in the gig economy and who had discrepancies between what was reported on their income tax returns and payments reported to IRS on **Forms 1099-K, Payment Card and Third Party Network Transactions**. "The review was limited to nine commonly recognized gig economy payer companies and identified 264,346 cases with potentially under-reported payments included on Form 1099-K." But, "many cases were *not* selected to be worked by the AUR program due to the large volume of discrepancies that were identified," TIGTA noted. In fact, 59% of taxpayers were *not* selected to be worked by the AUR. "AUR employees removed thousands of cases from inventory without justification or with justification that was inaccurate," adding that many of the cases worked by IRS examiners "were riddled with errors." The audit also noted that due to Treasury Department regulations, there are many taxpayers who earn income in the gig economy who do *not* even receive a **Form 1099-K**. **(Misc.; Form 1099-K)**

☞**Inadequate Record Keeping Spells Trouble for Uber Driver (*Nurumbi*, TC Memo. 2021-79 (6/20/2021))**

An Uber driver with missing records gets nailed by the IRS, along with the Tax Court. The taxpayer did do some driving for Uber throughout the year, but he also had others drive under his account. Uber deposited all payments into the taxpayer's bank account, and he then paid the other drivers working for him by electronic transfer or cash. He had no documents to substantiate the cash disbursements. Uber issued him a **Form 1099-K** (i.e., as an independent contractor), reporting $542,420 in payments that he failed to include in his gross income when he filed his personal return. The IRS adjusted the taxpayer's return to include the unreported income, while allowing a deduction for the electronic bank transfers to the other drivers, but *not* for the cash payments (for which he had no records). The Tax Court found the taxpayer's testimony to be credible, but still upheld the IRS's adjustments. **(Code §61; Gross Income)**

☞**IRS Reminder to Answer Virtual-Currency Question on Form 1040 (IR 2022-61)**

The Service is reminding taxpayers that they are required to answer the virtual-currency question when filing their return. The question asks: "At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?"

Comment: This "reminder" is equally applicable to any virtual currency questions for the 2023 tax year.

What is virtual currency? Virtual currency is a "digital representation of value, other than real currency (also known as "fiat currency"), that functions as a unit of account, a store of value, and a medium of exchange." But, for tax purposes, virtual currency "is treated as property, *not* currency." (**Notice 2014-21**)

IRS Requirement: Taxpayers must answer the virtual-currency question by checking either the "yes" box or the "no" box. In other words, the virtual-currency question must be answered by all taxpayers, even taxpayers who did *not* engage in a virtual-currency transaction in 2021.

Failure to Answer Question: The IRS has stated that if a taxpayer *e-files* a return without checking one of the virtual currency boxes, the return "will probably be rejected and the taxpayer will have a chance to correct the issue." If a taxpayer sends the IRS a *paper* return without checking one of the virtual currency boxes, the taxpayer will need to correct the return by mail.

When to Check "No" Box: Taxpayers who owned virtual currency at any time in 2021 but who did *not* engage in any virtual-currency transactions (i.e., buying, selling, trading, etc.) should check the "no" box. In addition, taxpayers may check the "no" box if their virtual currency activity was limited to:

- Holding virtual currency in their own wallet or account;

- Transferring virtual currency between their own wallets or accounts;

- Purchasing virtual currency using real currency, including purchases using real currency electronic platforms such as PayPal and Venmo; or

- Engaging in a combination of holding, transferring, or purchasing virtual currency as described above

When to Check "Yes" Box: Taxpayers must check the "yes" box if they have engaged in any of the transactions listed below:

- The receipt of virtual currency as payment for goods or services provided;

- The receipt or transfer of virtual currency for free (i.e., without providing any consideration) that does *not* qualify as a bona fide gift;

- The receipt of new virtual currency from mining and staking activities;

- The receipt of virtual currency from a "hard fork;"

- An exchange of virtual currency for property, goods, or services;

- An exchange/trade of virtual currency for another virtual currency;

- A sale of virtual currency; and

- Any other disposition of a financial interest in virtual currency

Comment: For more information, see the IRS's **Frequently Asked Questions** on virtual currency transactions.

Reporting Virtual-currency Transactions on Form 1040: A taxpayer who held virtual currency as a capital asset and disposed of it through a sale, exchange or transfer must check the "yes" box and use **Form 8949, Sales and Other Dispositions of Capital Assets**, to figure their capital gain or loss and report it on **Schedule D**. On the other hand, a taxpayer who received virtual currency as compensation for services or disposed of any virtual currency that they otherwise held for sale to customers in a trade or business (i.e., inventory), must report the income as they would report the same type of income (e.g., W-2 wages on **Line 1** of **Form 1040**, or sales or services income on **Line 1** of **Schedule C**). **(Misc.; Virtual Currency)**

☞**Treatment of Certain Nonfungible Tokens as Collectibles (IR 2023-50)**

A Nonfungible Token (NFT) is a "unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset." The IRS intends to issue guidance related to the treatment of certain NFTs as **Code §408(m)** "collectibles." This treatment is also relevant for other purposes of the Code, including the long-term capital gains tax rate under **Code §1(h)**. Until additional guidance is issued, the IRS intends to determine when an NFT is treated as a collectible by using a "look-through analysis." Under the look-through analysis, an NFT is treated as a collectible if the NFT's associated right or asset falls under the definition of collectible in the Code.

Comment: Collectibles are considered "alternative investments" by the IRS and include things like art, stamps, coins, cards, comics, rare items, antiques, and so on. If collectibles are sold at a gain, taxpayers are subject to a long-term capital gains tax rate of up to 28% (along with the possible imposition of the 3.8% Medicare surtax), if disposed of after *more than one year* of ownership. Collectibles sold at a gain are subject to ordinary income tax rates if held for *one year or less*.

Comment: The statutory tax rate on collectible capital gains (after all applicable netting of capital gains and losses) is a maximum 28% rate or the rate at which the gain would be taxed if it were ordinary income, if *lower*. When taxpayers have ordinary income, collectible gains, unrecaptured Sec. 1250 gains, and other long-term capital gains, it is important to consider the order in which ordinary income and net capital gains are applied in order to determine the rate at which the collectible gain would be taxed if it were ordinary income. Ordinary income is taxed first, followed by 25% gain, followed by 28% gain, and then the 0%/15%/20% gain.

Comment: If you do have a client with any "collectible gains or losses," there is an excellent **Tax Advisor** article which covers all of the details in making the applicable tax calculation.

Comment: Except for an investment in certain coins, IRA and qualified retirement plan funds cannot be used to invest in "collectibles" since this would be treated instead as a taxable distribution.

☞IRS Announces Direct E-File Pilot Program to be Available in 13 States (IR 2023-192)

The IRS has announced key details about its **Direct File** pilot program for the 2024 filing season. The test program will be available in Alaska, Arizona, California, Florida, Massachusetts, Nevada, New Hampshire, New York, South Dakota, Tennessee, Texas, Washington, and Wyoming. Eligible taxpayers in these states will have the option to electronically file their federal tax return directly with the IRS for free. Arizona, California, Massachusetts, and New York are also working to integrate their state taxes into the **IRS Direct File** program. The IRS anticipates the pilot will be limited to taxpayers that have "relatively simple returns," such as those with W-2 wage income, Social Security or railroad retirement income, unemployment compensation, the earned income tax credit, a child tax credit, a credit for other dependents, the standard deduction, a deduction for student loan interest, or a deduction for educator expenses. **(Misc.; IRS Direct File)**

☞Intuit Settles State-Level False-Advertising Claims While FTC Case Drags On

Intuit has **agreed** to pay $141 million to settle state false-advertising claims brought by all 50 states and the District of Columbia, claiming the maker of tax filing software tricked millions of customers into paying for TurboTax products that had been advertised as "free." But Intuit still faces legal troubles over its advertising program. The FTC sued Intuit over what its complaint called the company's deceptive 'free' filing ads. Acknowledging the settlement, Intuit general counsel Kerry McLean, in a statement posted on the company's website, said the settlement also "addresses the issues at the core of the Federal Trade Commission's litigation, making that lawsuit entirely unnecessary." However, the FTC indicated it would continue pursuing a false-advertising case against the company before an administrative judge. **(Misc.; Turbo Tax)**

Comment: Usage of IRS's **Free File Program** is pathetic with only 2% to 4% of eligible taxpayers using the program each year to electronically file the **Form 1040** or **1040-SR**. **Free File** is supposed to allow individual taxpayers with AGIs of $73,000 or less use free commercial tax software to prepare and e-file their returns. Two years ago, there were 10 participating tax preparation firms. This year, there are eight with one of the dropouts being Intuit.

☞FTC Sues Turbo Tax over Its "Free Filing" Claim

According to the FTC federal consumer protection agency Intuit, which is the owner of popular tax preparation software TurboTax, mischaracterizes its "free tax filing service" in commercials and on the product's website, as most customers do ultimately end up paying something to file their tax return (especially for the state or local returns). Only customers filing a "simple return" with TurboTax can do so without any additional charge. Based on the company's website, this supposedly applies to 60 million taxpayers. Nevertheless, "simple returns" are limited to **Form 1040** and can only include Form W-2 income and other specified tax situations. As a result, customers *cannot* attached any schedules (i.e., Schedules 1, 2 or 3, or the Schedules A, B, C, D, E or F which feed into these summary schedules). And, Intuit has the option to change what constitutes a "simple return" at any point in time.

The disclaimer that all but the most simple returns can be "filed for free" is buried on the TurboTax website. The input process has evolved over the years, but what has *not* changed is the use of a "file for $0" button while a separate, smaller hyperlink leads the user to the "simple return" explanation screen. It's not until the individual completes this process before being told at a "Hard Stop" that payment is required. "In the case of the Hard Stop screens, this confrontation comes *after* consumers have already created a TurboTax account and expended substantial time inputting sensitive personal and financial information into Intuit's user interface," the FTC complaint asserts. **(Misc.; Turbo Tax)**

> **Example:** Amanda has only a W-2 from her one job, while also receiving some interest or dividends which need to be reported on Schedule B. She uses the standard deduction and has no deductions "for AGI" such as student loan interest. After spending in an hour or more setting up a Turbo Tax account and inputting her personal information, she is then informed that the filing of her 2021 **Form 1040** and Wisconsin state income tax return will cost $130. It is only at this point in time, she is told that the IRS has a **Free Fillable Form** file option (while WI has fillable forms as well). But, given she is getting a total $3,600 refund between her federal and state return, she decides it is *not* worth the trouble of having to repeat the preparation process with these truly free alternative options.
>
> **Comment:** Intuit responded in a recent blog post, stating that it would "vigorously challenge" the FTC's complaint. Kerry McLean, an executive vice president and general counsel of the company, said the FTC's points "are simply not credible," and that "companies will be much less willing to enter into public-private partnerships with the government" following the agency's action. In response, Samuel Levine, director of the agency's Bureau of Consumer Protection, retorted, "TurboTax is bombarding consumers with ads for 'free' tax filing services, and then hitting them with charges when it's time to file."

☞**Life Cycle of a Tax Return** (**NTA Blog**)

The National Taxpayer Advocate has outlined the steps that the IRS takes when it receives a return before the return is officially posted to the IRS's systems. According to the NTA, once a return is received by the IRS, but before it posts to the IRS's systems, it goes through a series of "pre-posting reviews" to ensure the information on the return is correct. The IRS uses automated processes for some of these pre-posting reviews. If the IRS's automated pre-posting reviews finds that there are *not* any errors on the return, generally the return is then processed. On the other hand, if one of the IRS's automated pre-posting reviews identifies an error on a return, then the return must be reviewed. There are four main reasons why a return may need to be reviewed: (1) Error resolution; (2) Rejected returns; (3) Unpostable returns; and (4) Suspected identity theft.

> **Error Resolution:** Once errors on a return are identified, the IRS can:

1. Reject the error and manually release the taxpayer's refund; or

2. Confirm the error and notify the taxpayer that the IRS has used its "math error authority" to correct the error.

IRS Math Authority: Pursuant to **Code §6213(b)(1)** under its "math error authority," the IRS can summarily assess and collect tax without following the normal "deficiency procedures" (i.e., without first providing the taxpayer with a notice of deficiency). Instead, the Service can simply correct "mathematical and clerical" errors found on a taxpayer's return. The definition of "mathematical and clerical" errors is contained in **Code §6213(g)(2)**.

Rejected Returns: If the identified error on a return is *not* an error that the IRS can use its math error authority to correct, then the return may be rejected. Rejected returns are usually missing some required part of a return, such as a schedule or a form, which the IRS needs to properly process the return. In this case, the IRS will typically send the taxpayer **Letter 12C, Individual Return Incomplete for Processing**. This letter gives the taxpayer 20 days to supply the IRS with the missing schedule or form. If the taxpayer does *not* respond within 20 days, the IRS will adjust the return (which usually results in a reduced refund or increased tax liability).

Unpostable Returns: "Unpostable returns" are usually paper returns that have errors so significant that the IRS is *not* able to process them. The most common cause of unpostable tax returns is a mismatch between the taxpayer's identification number and name (i.e., the taxpayer's social security number as opposed to the name on file with the Social Security Administration). In instances such as this, the IRS will send the taxpayer a letter informing them of the problem and instructing them to correct their name with the SSA.

Suspected Identity Theft: Before they are posted to the IRS's systems, returns are screened by the IRS's identity theft/fraud detection filters. If the IRS's identity theft/fraud detection filters select a return, then the return is sent to the **Taxpayer Protection Program (TPP)** for further scrutiny. The TPP will send the taxpayer a letter asking them to authenticate their identity either over the phone, online, or by visiting a Taxpayer Assistance Center. **(Misc.; Tax Return Processing)**

☞**Taxpayers Now Have More Options to Correct, Amend Returns Electronically (IR 2022-130)**
The IRS recently announced that more forms can now be amended electronically. These include people filing corrections to the **Form 1040-NR, U.S. Nonresident Alien Income Tax Return** and **Forms 1040-SS, U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)** and **Forms 1040-PR, Self-Employment Tax Return – Puerto Rico**.

"This initiative has come a long way from 2020 when we first launched the ability to file amended returns electronically, which was an important milestone to help taxpayers and the tax community," said IRS Commissioner Chuck Rettig. "This new feature will further help people needing to make corrections. This development will also assist the IRS with its inventory work on the current backlog of amended returns. This is another tool we're using to help get us back on track."

Furthermore, a "new, electronic checkbox" has been added for **Forms 1040/1040-SR**, **1040-NR** and **1040-SS/1040-PR** "to indicate that a superseding return is being filed electronically." A "superseded return" is one that is filed *after* the originally filed return but submitted *before* the due date, including extensions.

Taxpayers can also amend their return electronically if there is change to their filing status or to add a dependent who was previously claimed on another return.

About 3 million **Forms 1040-X** are filed by taxpayers each year. Taxpayers can still use the **"Where's My Amended Return?"** online tool to check the status of their electronically-filed Form 1040-X.

Forms 1040, **1040-NR** and **1040-SR** can still be amended *electronically* for tax years 2019, 2020 and 2021 along with corrected **Forms 1040-SS** and **Form 1040-PR** for tax year 2021. **(Misc.; Amended Returns)**

> **Comment:** The IRS is reminding taxpayers that they still have the option of submitting a *paper* version of the **Form 1040-X** and should follow the instructions for preparing and submitting the paper form.

> **Comment:** As of June 11, the Service had a backlog of 2.1 million unprocessed **Forms 1040-X**. Normally, it can take IRS up to 16 weeks to handle an amended return. Now the wait time is more than 20 weeks for *e-filings* and is running considerably longer if you file a *paper* amended return.

> **Comment:** The IRS continues to emphasize that "it is continuing to look at this important area, and more enhancements are planned for the future."

☞**National Tax Advocate Confirms IRS Handling of Paper-filed Returns Antiquated**

The IRS's processing of paper-filed returns is "antiquated and time-consuming" according to this recent **assessment** by the National Taxpayer Advocate's office. IRS workers are required to manually transcribe the information on paper returns for input into the Service's computer systems by keystroking each amount on the submitted forms. The process, besides being extremely tedious, takes lots of time and results in a significant amount of data entry errors. In fact, about 22% of paper returns transcribed by IRS employees in 2021 had such errors. According to the NTA, there is a possible solution. Namely, the use of scanning technology. One option is to add bar codes to paper 1040s filed by people who use tax software to prepare their returns but then mail them to the Service instead of e-filing them. A second possibility is to implement optical character recognition technology for paper returns. The NTA has directed IRS to put scanning in place for the 2023 filing season (and, the Service has until May 31st to respond to the directive). **(Misc.; Paper-filed Returns)**

☞**IRS Refund Tool Tracks Current and Prior 2 Tax Years (IR 2022-109)**

The IRS updated its **"Where's My Refund?"** tool to allow taxpayers to check the status of their current as well as two prior years' refunds. To access **Where's My Refund?**, a taxpayer will need their Social Security number (SSN) or Individual Taxpayer Identification number (ITIN), filing status and the amount of their expected refund from the original tax return for whichever tax year they are checking.

> **Comment:** Refund information available to those attempting to call the refund hotline will be limited to only the *current* year tax return (i.e., for the 2021 tax year).

When using the IRS **Where's My Refund?** website, taxpayers can check the status of their refund within:

- 24 hours after e-filing a tax year 2021 return;

- Three or four days after e-filing a 2019 or 2020 return; or

- Four weeks after mailing a return

Where's My Refund? also allows taxpayers to track their refund through three stages of the process:

- Return received;

- Refund approved; and

- Refund sent

Once a taxpayer's refund is approved, **Where's My Refund?** will give the taxpayer a projected refund issuance date.

> **Comment:** Keep in mind that the IRS **Where's My Refund?** website is updated once a day, usually overnight, so a taxpayer should only check it once a day.

As far as actually attempting to call the IRS regarding a refund, a taxpayer should call the IRS about their refund only if **Where's My Refund?**:

- Is *not* showing the return was received or the refund approved and it's been more than 21 days since the return was filed electronically, or

- Shows a refund was sent, but the taxpayer has *not* received it after 15 days, or

- Says the IRS can provide more information about the refund's status. **(Misc.; Tax Refunds)**

☞**IRS Releases Updated List of Automatic Changes in Accounting Methods (Rev. Proc. 2023-24)**
The IRS has released **Rev. Proc. 2023-24**, updating and replacing **Rev. Proc. 2022-14**, which was the previous list of accounting method changes for which the "automatic change procedures" of **Rev. Proc. 2015-13** apply. **Rev. Proc 2023-24** is effective immediately for **Form 3115 (Application for Change in Accounting Method)**, filed *on or after* 6/15/23, for a year of change ending *on or after* 10/31/22. The IRS has also provided transition rules for **Form 3115** filed under the *non-automatic* and the automatic change procedures in **Rev. Proc. 2015-13** if the taxpayer filed the form *before* 6/15/23 and the form is pending, transition rules for filing **Form 3115** for changes in methods of accounting that can no longer be filed under the automatic change procedures listed in the "significant changes" section are also discussed.

> **Comment:** Some of the most popular "automatic changes in accounting methods" involve the ability to "catch up" on missed depreciation (including bonus depreciation) where the taxpayer has misclassified an asset when it is first placed in service (or, upon a cost segregation study being done), or has otherwise just failed to claim any write-off at all. Another possible automatic change in accounting method could involve a situation where the taxpayer no longer meets the requirements to be treated as a "qualified small business" (i.e., their average gross receipts over the three most recent tax years is more than $27 million).

> **Comment:** "Automatic changes in accounting method" still involved the required filing of **Form 3115**, but there is no fee to be paid and the IRS has no discretion in granting the request.

☞**Revised Form 3115 Change in Accounting Method Released (Ann. 2023-12)**
The IRS has revised **Form 3115, Application for Change in Accounting Method**, and its **Instructions**. The **Form 3115 (Rev. December 2022)** is the current form and it replaces the December 2018 version of the **Form 3115**. **Ann. 2023-12** also provides guidance to allow for a "reasonable period" for taxpayers to transition to the December 2022 **Form 3115**. **(Code §446; Form 3115)**

> **Comment:** In the **Kiplinger Tax Letter (4-13-23)** it clarified that for returns filed before April 18, 2023, *either* 2018 or the 2022 version could be used. However, going forward, it stated that the revised 2022 version must be used for all **Form 3115** requests.

> **Comment:** Even though it is an "automatic consent" change in accounting method to "catch up" on any missed depreciation or amortization, **Form 3115** must still be filed with the IRS. In a recent

case, a company that owns and leases farmland, including "base acres" (which are essentially a contractual right to receive federal farm subsidies for producing certain commodities) failed to amortize these rights. Instead of filing **Form 3115** to catch up on this missed amortization, the company simply started to take the write-off on a prospective basis. The Tax Court upheld the Service's determination that the deduction should be disallowed. (Cf. ***Conmac Investments*, TC Memo. 2023-40 (3/27/2023)**)

☞**IRS Website Devoted to Marijuana Industry**

The IRS has launched a website devoted to the marijuana industry. Among other things, the site addresses **Code §280E**, which disallows all deductions or credits for amounts paid or incurred in carrying on a trade or business that involves the "trafficking of a controlled substance." However, marijuana businesses are still permitted to reduce their gross receipts by cost of goods sold. The site also highlights issues unique to marijuana businesses that conduct transactions primarily in cash. For example, cash payment options, such as making a payment at an IRS Taxpayer Assistance Center, are available for "unbanked taxpayers." In addition, any person in a trade or business who receives more than $10,000 in cash in a single transaction (or, in related transactions) must file **Form 8300** **(Report of Cash Payments Over $10,000 Received in a Trade or Business)** within 15 days after receiving payment. **(Misc.; Marijuana)**

☞**Are Marijuana Business Profits Eligible for Sec. 199A Deduction?**

Can the owners of a marijuana business claim the Sec. 199A 20% deduction for K-1 income? At a recent ABA tax section meeting Luke Ortner of the **IRS Office of Chief Counsel (Small Business/Self-Employed)** confirmed that result. But he also explained that when calculating the factors for determining whether a taxpayer is eligible for the deduction, **Code §280E** still comes into play. **Code §280E** denies deductions or credits for the business expenses of any trade or business that traffics in controlled substances, including state-legal cannabis businesses, other than for the cost of goods sold. But given that this endeavor constitutes a "trade or business," **Code §199A**, enacted by the **Tax Cuts and Jobs Act**, provides for a deduction of up to 20 percent of passthrough income for qualified business owners. **(Code §199A; Sec. 199A Deduction)**

> **Comment:** The denial of all business expenses except COGS brings into play an interesting question. Namely, any "qualified business income" (QBI) from such businesses will correspondingly be higher given that all other types of trade or business expenses are denied under **Code §280E**.

☞**IRS Tax Pro Account (IR-2021-154)**

The IRS launched a new feature that will give taxpayers digital control over who can represent them or view their tax records. The new feature will allow individual taxpayers to authorize their tax practitioner to represent them before the IRS with a Power of Attorney (POA) and to view their tax accounts with a Tax Information Authorization (TIA). Tax professionals may go to the new **Tax Pro Account** to digitally initiate POAs and TIAs. A key benefit is the completed digital authorization, if accurate, will go directly to the Centralized Authorization File (CAF) database and will *not* require manual processing. Most requests will be immediately recorded and appear on the list of approved authorizations in the taxpayer's **Online Account** and the tax professional's **Tax Pro Account**. Tax professionals may then go to **e-Services Transcript Delivery Service** to see the taxpayer's records. **(Misc.; Tax Pro Account)**

> **Comment:** Only tax practitioners with CAF numbers are permitted to use the Tax Pro Account. **Form 2848** is the power-of-attorney document for audits and inquiries. **Form 8821** permits IRS to disclose information to a tax pro or other person.

☞**IRS Announces New Capabilities for Tax Pro Accounts (IR-2023-182)**

As part of a larger effort to improve technology, the Service has announced an expansion of the **Tax Pro Account** capabilities that allows tax professionals access to new services to help their clients. These new additions will help practitioners manage their active client authorizations on file with the **Centralized Authorization File** **(CAF)** database. Other enhancements will allow tax professionals to view their client's tax information, including balance due amounts. **Tax Pro Account** users can now also "withdraw from their active authorizations online in real time."

These changes reflect ongoing transformation efforts made possible under the **Inflation Reduction Act**. The IRS stated that "tax professionals are a critical part of the nation's tax system, and the new **IRS Strategic Operating Plan** highlights the need to improve technology and services for taxpayers as well as tax professionals."

Tax Pro Account New Features: The new enhancements continue IRS efforts "to improve the third-party authorization process." The IRS also continues to work "on additional expansions to improve services to taxpayers and their tax professionals." **Tax Pro Account** thus continues expanding with the following new features:

- **Tax Pro Account** provides tax professionals with a "digital self-service portal" they can rely on to manage their authorization relationship with taxpayers and view the taxpayers' information.

- With the recent enhancements, tax professionals can now use **Tax Pro Account** to send **Power of Attorney** **(POA)** and **Tax Information Authorization** **(TIA)** requests directly to a taxpayer's individual **IRS Online Account**. Upon the taxpayer's approval and validation of the information, the authorization records immediately to the Service's CAF database, which avoids faxing, mailing, uploading and long review and processing time by the CAF Unit.

- Tax professionals must have a CAF number to use a **Tax Pro Account**. A CAF number, however, cannot be requested through the **Tax Pro Account**. Currently, the digital authorization process is available only for individual taxpayers, *not* businesses or other entities.

- More than 260,000 people have used **Tax Pro Account** since it launched in July 2021 and the webpage has been viewed over 2.7 million times.

Comment: For more detailed information, the following resources are available: (1) **IRS Pub. 5533-A, How to Submit Authorizations Using Tax Pro Account and Online Account**; (2) **IRS Pub. 947, Practice Before the IRS and Power of Attorney**; and (3) **Power of Attorney and Other Authorizations**.

☞**Additional Information on New Tax Pro and Online Accounts (IRS Pub. 5533-B)**

The IRS is providing additional information on the **Tax Pro Account** function that it introduced in July 2021 "to facilitate authorizations by taxpayers with respect to their representatives." The IRS has also provided additional information regarding **IRS Online Account** function, which allows individual taxpayers access to their tax account information.

Background - Tax Pro Accounts: **Form 2848, Power of Attorney** form, is a taxpayer's written authorization appointing an eligible individual to represent the taxpayer before the IRS, including performing certain acts on the taxpayer's behalf. It also authorizes the representative to receive related confidential tax information of the taxpayer from the IRS. **Form 8821, the Tax Information Authorization** form, is a taxpayer's written authorization designating a third party to receive and view the taxpayer's information.

Tax professionals will now be able to go directly to their **Tax Pro Account** to digitally initiate POAs and TIAs. Once completed and submitted by the tax professional, the authorization requests will appear in the taxpayers' **Online Account** for their review, approval and electronic signature, or rejection. Because the taxpayers' identities already are verified at the time of login, taxpayers will only need to check a box as their signature and submit the authorization request to IRS.

Comment: At the current time, the digital authorization process is available only to individual taxpayers, and *not* to businesses or other entities.

Background - Online Accounts: The **Online Account** function is IRS's online system that allows individual taxpayers to access their personal account information.

Additional Information re: Tax Pro Account: The IRS has provided the following additional information regarding the **Tax Pro Account**:

- Taxpayers can authorize multiple representatives/designees.

- IRS e-authentication for both the taxpayer and the representative/designee can be obtained through **Tax Pro Account**.

- Using **Forms 2848** and **8821** for third-party authorizations remains an option for those individual taxpayers who do *not* have or are unable to register for an **Online Account**, who have more complex tax matters requiring the use of a form, or for business taxpayers.

Comment: These forms can be uploaded using **"Submit Forms 2848 and 8821 Online"** as well as e-faxed or mailed.

Additional Information re: Online Accounts: The IRS has provided the following additional information about **Online Accounts**. Taxpayers cannot only approve authorization requests via their **Online Account**, but, they will also be able to review their past Economic Impact Payment amounts, get to the Child Tax Credit Update Portal, see selected IRS notices and access transcripts via Get Transcripts, and perform other tasks. They can also see their payment history and make payments online. **(Misc.; IRS On-line)**

Tax Professionals Must Now Use ID.me to Access IRS Web Tools

Tax professionals will no longer be able to use **Secure Access** to sign in on IRS web base tools such as the **e-Services** suite of online applications. Now, practitioners will be required to create **accounts** and validate their identities with **ID.me** technology which the Service is using for all of its web base applications. **(Misc.; ID.me)**

☞**IRS Reminds Individuals Benefits of On-line Accounts (Tax Tip 2021-107)**

An IRS online account is a “safe and easy way” for individual taxpayers to view specific details about their federal tax account. Here are some of the benefits and features of this online system:

1. Taxpayers can view:

- Their payoff amount, which is updated for the current day
- The balance for each tax year for which they owe taxes
- Their payment history
- Key information from the their most current tax return as originally filed
- Payment plan details if they have one

- Digital copies of select IRS notices
- Economic Impact Payments if they received any
- Their address on file

2. After viewing their information, a taxpayer can:

- Select an electronic payment option
- Set up an online payment agreement
- Go directly to **Get Transcript**

New Authorization Feature: The new "authorization" option in Online Account also allows taxpayers to control who can represent them before the IRS or view their tax records. They can also approve and electronically sign Power of Attorney and Tax Information Authorization requests from their tax professional. The taxpayer's balance will update no more than once every 24 hours, usually overnight. Taxpayers should also allow 1 to 3 weeks for payments to show up in the payment history. To access their information online, taxpayers must register through **Secure Access**. This is the agency's "two-factor authentication process" that protects personal info. Taxpayers can also review the **Secure Access** page process prior to starting registration. **(Misc.; Tax On-line Account)**

☞**Identification Guidelines When Contacting IRS** (**Tax Tip 2021-110**)

Taxpayers and tax professionals contacting the IRS on behalf of their clients will be asked to verify their identity. The Service explained that this "is part of the agency's ongoing efforts to keep taxpayer data secure from identity thieves."

The IRS emphasized that before calling, "everyone should visit **IRS.gov** website to access resources like the **Let Us Help You** page to get faster answers to their tax questions."

If a taxpayer or their advisor decides to call, they should know that IRS phone assistors "take great care to only discuss personal information with the taxpayer or someone the taxpayer authorizes to speak on their behalf." To make sure that taxpayers do *not* have to call back, the IRS reminds taxpayers to have the following information ready:

- Social Security numbers and birth dates for those who were named on the tax return;

- An **Individual Taxpayer Identification Number** letter if the taxpayer has one instead of an SSN;

- Their filing status: single, head of household, married filing joint or married filing separate;

- The prior-year tax return since IRS phone assistors may need to verify taxpayer identity with information from the return before answering certain questions;

- A copy of the tax return in question; and

- Any IRS letters or notices received by the taxpayer

By law, IRS telephone assistors will only speak with the taxpayer or to the taxpayer's **legally designated representative**. Furthermore, if taxpayers or tax professionals are calling about someone else's account, they should be prepared to verify their identities and provide information about the person they are representing. Before calling about a third-party, they should have the following information available:

- Verbal or written authorization from the third-party to discuss the account;

- The ability to verify the taxpayer's name, SSN or ITIN, tax period, and tax forms filed;

- **Preparer Tax Identification Number** or PIN if a third-party designee;

- One of these forms, which is current, completed and signed: (1) **Form 8821, Tax Information Authorization** or (2) **Form 2848, Power of Attorney and Declaration of Representative**.

☞**IRS Abatement v. Refund Claims (CCA 202137009)**
The IRS has outlined the difference between a "claim for refund" and a "claim for abatement." The CCA states that if a claim asks for a refund, then it is a claim for refund. A balance-due at the time of the claim is irrelevant. What matters is if there would be a balance-due even if the claim is allowed. For example, assume there is a $10k liability reported and assessed. The taxpayer has paid $8k, and there is a $2k balance-due. The taxpayer files a claim alleging that the liability is actually $7k. As a result, this would be a "claim for refund." If allowed, the $2k balance -due would be abated as being excessive. Furthermore, $1k would be refunded as an overpayment (i.e., $8k paid - $7k liability = $1k overpayment). Alternatively, assume there is a $10k liability reported and assessed. The taxpayer has paid $8k and there is a $2k balance-due. The taxpayer files a claim alleging the liability is actually $8k. This is a "claim for abatement."

If allowed, $1k of the $2k balance-due would be abated as being excessive. In other words, the claim does *not* seek any refund. Note, however, that in both situations there was a balance-due. The CCA emphasizes that this is *not* relevant. The distinguishing feature between the two claims is that in the first, the taxpayer is asking for a refund. The denial of this claim can form the basis of jurisdiction in a later court action. In the second, the taxpayer is *not* asking for a refund. This second claim would *not* form the basis of a "justiciable controversy." However, that is *not* a problem. The taxpayer will always be able to sue for refund if they are ever put into an overpayment situation, because that could only happen prospectively, and there will be new claim-filing deadlines with respect to any claims that seek the return of prospective payments (whether voluntary or not). **(Misc.; Tax Refunds)**

☞**Challenging IRS Positions (Tax Tip 2021-129)**
Taxpayers have the right to challenge the IRS's position and be heard. This is part of the **Taxpayer Bill of Rights**, which clearly outlines the following fundamental rights every taxpayer has when working with the IRS. Taxpayers have the right to:

- Raise objections
- Provide additional documentation in response to formal or proposed IRS actions
- Expect the IRS to consider their timely objections
- Have the IRS consider any supporting documentation promptly and fairly
- Receive a response if the IRS does not agree with their position
- Being informed of some specific things this right affords taxpayers

In some cases, the IRS will notify a taxpayer that their tax return has a math or clerical error. If this happens, the taxpayer:

- Has 60 days to tell the IRS that they disagree
- Should provide copies of any records that may help correct the error
- May call the number listed on the letter or bill for assistance
- Can expect the agency to make the necessary adjustment to their account and send a correction if the IRS upholds the taxpayer's position

Here is what will happen if the IRS does *not* agree with the taxpayer's position:

- The agency will issue a notice proposing a tax adjustment (this is a letter that comes in the mail)
- This notice provides the taxpayer with a right to challenge the proposed adjustment
- The taxpayer makes this challenge by filing a petition in U.S. Tax Court. The taxpayer must generally file the petition within 90 days of the date of the notice (or, 150 days if it is addressed outside the United States)
- Taxpayers can submit documentation and raise objections during an audit. If the IRS does *not* agree with the taxpayer's position, the agency issues a notice explaining why it is increasing the tax. Prior to paying the tax, the taxpayer has the right to petition the U.S. Tax Court and challenge the agency's decision.

In some circumstances, the IRS must provide a taxpayer with an opportunity for a hearing before an independent Office of Appeals. The agency must do this before taking enforcement actions to collect a tax debt. These actions include levying the taxpayer's bank account immediately after filing a notice of federal tax lien in the appropriate state filing location. If the taxpayer disagrees with the decision of the Appeals Office, they can petition the U.S. Tax Court. **(Misc.; IRS Conflicts)**

☞**IRS Guidance on Penalties & Payments** (**Tax Tip 2021-130**)

Taxpayers can find answers to most questions about tax payments and penalties on **IRS.gov**. The **Let Us Help You** website features links to information and resources on a wide range of topics related to penalties and payments.

- With regard to tax payment options, this page lays out the different ways taxpayers can pay what they owe, from having the payment taken directly from their bank account to using a credit card.

- As far as the IRS payment plan, taxpayers who cannot pay what they owe in full can learn their options on this page.

- Taxpayers can also view balance and payment history. Individual taxpayers can use this tool to check their account and see things like the total amount they owe and their payment history.

- For both liens and levies, this website explains what a lien and a levy are, and the effect of each legal action.

- It is also possible to resolve a dispute with the **Office of Appeals** which is an independent organization within the IRS that helps taxpayers resolve their tax disputes. This page has links to information that will help taxpayers who received a notice saying their case qualifies to be reviewed by Appeals.

- For taxpayers who owed more than expected when they filed this year have a couple options to help them avoid that when they file next year. These pages have more info about the options.

- There are links that cover IRS penalties and direct the user to information where they can find out more about topics related to penalties and penalty relief. **(Misc.; IRS Penalties)**

☞**IRS Reminder for 2023 PTIN Renewals** (**IR 2022-190**)

The IRS is reminding 750,000 federal tax return preparers they must renew their Preparer Tax Identification Numbers (PTINs) now for 2023 since all current PTINs will expire as of 12/31/22. Anyone who prepares (or, assists in preparing) a federal tax return for compensation must have a valid PTIN from the IRS before preparing returns. The PTIN needs to be included as the identifying number on any return filed with the IRS. All enrolled agents must also have a valid PTIN. The non-refundable fee to renew or obtain a PTIN is $30.75 for 2023. Tax preparers with a 2022 PTIN should use the online renewal **process**. However, **Form W-12** is available for *paper* renewals with a four-to-six-week processing time.

Failure to have and use a valid PTIN may result in penalties. **(Misc.; PTIN Renewal)**

Reduced Fees to Obtain or Renew a PTIN (TD 9980)

The IRS has issued interim final regulations that reduce the user fees paid by tax preparers to obtain a preparer tax identification number (PTIN). Under the new regulations, the cost of obtaining or renewing a PTIN will drop to $11 (plus $8.75 for a third-party contractor). In 2022, the fee to obtain or renew a PTIN was $30.75. Under **TD 9501**, the IRS requires certain tax preparers to include a PTIN on a return, statement, or other document required to be filed with the IRS. This year, the IRS is using a new "cost model" to determine the costs related to the PTIN program because a federal district court determined the PTIN fee the IRS was charging preparers was excessive. **(Code §6109; PTINs)**

Comment: These new regulations are effective on 10/19/23.

☞**Employee Working on Company's Tax Return Need Not Sign as Preparer (PTIN FAQ #9)**

The IRS has confirmed that employees who prepare their employer's returns are *not* to be treated as the "tax return preparer" under the Service's administrative laws. Therefore, they are *not* required to sign the returns as such. The IRS recently confirmed this in a ruling in which an individual employed by a corporation did returns for employees and LLCs owned by the firm. These employees are technically *not* "preparers" merely because they prepare returns for an employer, for related entities or for company officers and employees. **(Misc.; Tax Return Preparers)**

☞**IRS Response to Stolen Identity and Fraudulent Tax Returns (Fact Sheet 2022-25)**

The IRS has put together some information about how taxpayers should handle both non-tax and tax-related identity theft.

Tax-related Identity Theft: Tax-related identity theft occurs when someone uses a taxpayer's lost or stolen SSN or individual tax identification number (ITIN) to file a tax return claiming a fraudulent refund. In most tax-related identity theft cases, the IRS will identify a suspicious tax return and pull it for review. Once the IRS pulls a return for review, the IRS will send a letter to the taxpayer requesting additional information. In the meantime, the IRS will *not* process the pulled return until the taxpayer responds to the IRS's letter.

Depending on the specifics of the situation, a taxpayer will receive one of three letters asking them to verify their identity:

- **Letter 5071C**, which asks a taxpayer to verify their identity using an online tool and confirm that they did (or did *not*) file the return in question.

- **Letter 4883C**, which asks the taxpayer to call the IRS to verify their identity and confirm whether they did or did *not* file the pulled return.

- **Letter 5747C**, which asks the taxpayer to verify their identity in person at a Taxpayer Assistance Center (usually, this letter is used for taxpayers who have been a victim of a data breach).

Filing Form 14039: A taxpayer who thinks they have a tax-related identity theft problem (but has *not* received a letter from the IRS) should complete and submit **Form 14039, Identity Theft Affidavit**. But, if a taxpayer has already received any of the above-mentioned letters, they do *not* need to file a **Form 14039**. Instead, they should follow the instructions in the letter to verify their identity with the IRS.

Tax-related Identity Theft Indications: Signs that an individual has been the victim of tax-related identity theft include the following:

- A taxpayer cannot e-file their tax return because a tax return was already filed using their SSN.

- A taxpayer cannot e-file their return because a dependent's SSN or ITIN was already used on another return without the taxpayer's knowledge or permission.

Comment: In the situations above, taxpayers should first check that the SSN(s) or ITIN(s) on the return is correct and be sure a claimed dependent has *not* filed a their own tax return.

- A taxpayer receives a tax transcript in the mail they did *not* request.

- A taxpayer receives a notice from a tax preparation software company confirming an online account was created in their name, and they did *not* create one.

- A taxpayer receives a notice from their tax preparation software company that their existing online account was accessed or disabled when they took no action.

- A taxpayer receives an IRS notice informing them that they owe additional tax, or their refund was offset to a balance due, or that they have had collection actions taken against them for a year they did *not* earn any income or file a tax return.

- The IRS sends a taxpayer a notice indicating that the taxpayer received wages or other income from someone they did *not* work for.

- The taxpayer was assigned an Employer Identification Number (EIN), but they did *not* request or apply for an EIN.

After the IRS receives **Form 14039** from a taxpayer, the IRS will work to verify the taxpayer's identity and confirm that the taxpayer is the victim of tax-related identity theft. Once the IRS confirms the taxpayer is the victim of tax-related identity theft, the IRS will clear any fraudulent return from the taxpayer's account and place a “special code” on the taxpayer's account. This code will prompt the IRS to send the taxpayer an identity protection personal identification number (IP PIN) to the taxpayer each year.

Form 14039 Not Needed: Non-tax-related identity theft occurs when lost or stolen "personal identifiable information" (PII) is used to open credit cards, obtain mortgages, buy a car or open other accounts without the victim's knowledge. Potential evidence of “non-tax-related identity theft can include the taxpayer:

- Receiving balance due bills from companies the taxpayer did *not* do business with, magazine subscriptions they did *not* order, statements for a mortgage and/or credit cards they did *not* apply for.

- Receiving notices of unemployment benefits the did *not* apply for.

- Receiving a Form W-2 or Form 1099 from someone they did *not* work for or receive the reported income from but they have *not* received a notice or letter from the IRS questioning them about that income.

- A taxpayer cannot e-file their return because a dependent's SSN or ITIN was already used by someone who is known to the taxpayer but is *not* the parent or legal guardian, and the taxpayer did *not* provide permission for that person to claim the dependent.

Comment: For additional information about this last issue, see **IRS Pub. 1819, “Divorce and Non-custodial, Separated, or Never Married Parents.”**

Notice CP 01E, Employment Identity Theft: The IRS sends this notice when another person may have used the taxpayer's SSN to obtain employment but has *not* used it to file a tax return.

Victims of *non-tax-related* identity theft do *not* need to report these incidents to the IRS but should take steps to protect against the type of identity theft they might have experienced. **(Misc.; Identity Theft)**

☞IRS Outlines Merits of Getting Identity Protection PIN (IR 2022-78)

Identity Protection Personal Identification Numbers (IP PINs) are intended to protect taxpayers from tax fraud. But, the question remains as to whether a taxpayer should bother to get one (i.e., given that they have *not* already been assigned one by the IRS).

IP PINs: An IP PIN is a six-digit number that the IRS assigns to a taxpayer that serves as "two-factor authentication." Once an IP PIN is assigned to a taxpayer, only a person who has the taxpayer's IP PIN (and all the taxpayer's other identification information) can file a tax return for that taxpayer. As a result, an IP PIN can stop identity thieves from using a protected taxpayer's information to file a fraudulent tax return. An IP PIN also protects a taxpayer when they are *not* otherwise required to file a tax return because the IRS will reject any return that does *not* contain the taxpayer's IP PIN.

It would be advisable for taxpayers to request an IP PIN for themselves and their family when:

- They want to protect their SSN or ITIN from being used for filing fraudulent tax returns;

- They want to protect their dependent's SSN or ITIN from being used for filing fraudulent tax returns;

- They think their SSN, ITIN or personal information was exposed by accident, theft or fraud; or

- They suspect or know they are a victim of identity theft.

Obtaining IP PINs: Taxpayers may obtain an IP PIN using the **"Get an IP PIN"** tool on **IRS.gov**. The tool will lead the taxpayer through a complete identification check. Once the taxpayer has authenticated their identity, the tool will provide the taxpayer with an IP PIN. Once a taxpayer obtains an IP PIN, the IRS will *automatically* issue the taxpayer a *new* IP PIN every year. Once an individual is enrolled in the IP PIN program, there is no mechanism to opt-out. The IRS may automatically assign an IP PIN if the IRS determines the taxpayer is a victim of tax-related identity theft. The taxpayer will receive a notification confirming the tax-related ID theft incident along with an assigned IP PIN for future tax-return filings. **(Misc.; IP PIN)**

☞FAQs Issued on Identity Protection Personal Identification Numbers (IP-PIN)

On its **website**, the IRS has issued a series of FAQs concerning Identity Protection Personal Identification Number (IP PINs) which are discussed below.

Background: An IP PIN is a six-digit number assigned to eligible taxpayers to help prevent the misuse of their Social Security number (SSN) on fraudulent federal income tax returns. An IP PIN helps the IRS verify a taxpayer's identity and accept their electronic or paper tax return. When a taxpayer has an IP PIN, it prevents someone else from filing a tax return with the taxpayer's SSN. The IRS has issued a series of FAQs detailing the use of IP PINs as summarized below.

Q1: What's an IP PIN?

A1: The IRS IP PIN is a 6-digit number assigned to eligible taxpayers to help prevent the misuse of their Social Security number on fraudulent federal income tax returns. A *new* IP PIN will be generated *each* year. If the IRS has assigned a taxpayer an IP PIN, they must use it to confirm their identity on any return filed during the current calendar year. This includes current year returns as well as any delinquent tax returns.

Q3: What happens if I have an IP PIN and fail to use it correctly on my return?

A3: The IP PIN acts as an authentication number to validate the correct owner of the Social Security number(s) listed on your tax return. If you filed your return electronically and an IP PIN is *not* entered correctly, the return will be rejected and you will need to enter the correct IP PIN to e- File it again. If you lost the IP PIN or did *not* receive one in the mail, go to the IRS website to **retrieve your IP PIN**. If you filed your return on paper, you have an IP PIN, you are the primary and/or secondary taxpayer, and you fail to enter your IP PIN correctly, your return will take longer to process while we validate the information. This increased validation is for your protection, but it will delay any refund you may be due. The IRS also notes that the IP PIN(s) of dependents are *not* entered on *paper* tax returns.

Q4: I lost my IP PIN or I did not receive a new one in the mail. How do I get another one?

A4: If we issued you an IP PIN and you lost it or you did *not* receive a new one in the mail, you will need to obtain your IP PIN before you can e-file your return. You can get your current IP PIN by using the **Get an IP PIN** application. If you previously created an account, go to **Get an IP PIN** and log in to your account with your username and password. You may be required to verify your identity again due to our increased account security. Follow the prompts to get your current IP PIN. If you are unable to retrieve your IP PIN online, you may call us at 800-908-4490 for specialized assistance, Monday - Friday, 7 a.m. - 7 p.m. your local time (Alaska & Hawaii follow Pacific Time), to have your IP PIN reissued to you. An assistor will verify your identity and mail your IP PIN to your address of record within 21 days.

Q5: I'm a victim of identity theft. Can I get an IP PIN?

A5: Not necessarily. You will get an IP PIN if you meet one of the following criteria: you received an IP PIN last year, or you received a **CP01A notice**, or you received an IRS letter or notice inviting you to opt-in to get an IP PIN.

Q6: We're married and filing a joint return. How do we use/enter the IP PIN if 'one' or 'both' of us have one?

A6: Each taxpayer who has an IP PIN must enter it on their tax return.

Q7: My e-filed return was rejected and the reject code said I need an IP PIN. What do I do?

A7: In this situation, at least one SSN on your return has an IP PIN requirement and you will need to include the IP PIN on your tax return. If you, your spouse (if married filing jointly), or dependent had an IP PIN assigned prior to the filing season, it needs to be included on your return. If you do *not* know the IP PIN necessary to file, check the return reject code to see whether the IP PIN requirement belongs to you, your spouse, or your dependent (as applicable). You will need to retrieve that specific IP PIN prior to resubmitting your e-File return.

Q8: I reported to the IRS that I was the victim of identity theft but never received an IP PIN. Why didn't I receive one?

A8: Your identity theft case may *not* have been resolved prior to our issuance of new IP PINs in early

January or you moved prior to the end of the year and did not notify us. If we assigned you an IP PIN, you will need to **Retrieve Your IP PIN** to 'e-file' your tax return this year. You will know we assigned you an IP PIN if your e-filed return is rejected because it was missing an IP PIN.

Q9: Where is the IP PIN on my CP01A Notice?

A9: It is located on page one of the **CP01A notice** at the top of the first column.

Q10: Where do I enter the IP PIN(s) on my tax return?

A10: This is determined by the method you use to file, electronic or paper. If you filed *electronically*, then your tax software or practitioner will tell you where to enter the IP PIN. If you cannot find where to enter your IP PIN, search within your software for Identity Protection PIN or IP PIN or contact the software provider's help desk. Each taxpayer claimed on a tax return who receives an IP PIN must have their IP PIN(s) entered on the tax return. This includes the IP PIN of any dependent(s) included in the tax return, if applicable. If you claim a dependent who receives an IP PIN, you must enter it on the '**Form 1040** series' as well as '**Form 2441**' and '**Schedule Earned Income Tax Credit**'. For more information, please see **Question 17** below. If you filed a *paper* return, then *both* the primary taxpayer and secondary taxpayer needs to enter their IP PIN. Enter your IP PIN(s) as applicable in the boxes marked **"Identity Protection PIN"** in signature area of the return.

Q11: Do I have to use the IP PIN I received this year if filing prior year returns this year?

A11: Yes. You must use this IP PIN to confirm your identity on your current tax return and any prior year returns filed during the calendar year.

Q12: Why did I receive an IP PIN?

A12: Our records show you were previously the victim of identity theft; or you were identified by the IRS as a possible victim of tax-related identity theft. We use this IP PIN to authenticate your identity when you file.

Q13: I received an IP PIN for a deceased person. What do I do with it?

A13: If filing a return for the decedent enter the IP PIN as appropriate.

Q14: Do I have to keep this IP PIN and use it again next year?

A14: No. A new IP PIN will be generated each year.

Q15: When does the IRS send IP PIN notices to taxpayers?

A15: We send the **CP01A notice** in early January to taxpayers eligible to receive an IP PIN.

Q16: Should I give my IP PIN to anyone?

A16: You are encouraged to keep your IP PIN in a safe location until it is time to prepare your tax return. If you choose to hire a tax preparer or take advantage of a volunteer tax preparation service to prepare your tax return, you will need to provide your IP PIN so the preparer can include it on your return. When calling the IRS or visiting an IRS office, your IP PIN is *not* accepted as proof of your identity.

Q17: Do I include my dependent's IRS issued IP PIN on my federal tax return?

A17: This is determined by how you file. If you file your return *electronically*, and you claim one or more dependents that have an IP PIN, you must enter their IP PIN on the following e-File tax forms: **Form 1040, Individual Income Tax Return**, and series **Form 2441, Child and Dependent Care Expenses** and **Schedule Earned Income Credit**. Your e-File return will be rejected if you fail to enter a dependent's IP PIN. If you instead file a *paper* return, then you do *not* need to enter an IP PIN for your dependent(s) when filing a paper tax return.

Q18: Should I include my IP PIN on Forms such as the 1040X, Amended Return, Form 4868, Automatic Filing Extension, or when I file my state tax return?

A18: No. The IP PIN is only used on federal tax **Forms 1040** and **1040PR/SS**.

Q19: Will I get my refund faster if I use my IP PIN?

A19: How quickly you receive your refund depends on your individual return information. If you include your IP PIN when filing, your return will be subject to the same validity checks as other returns *not* requiring an IP PIN. **(Misc.; IP PIN)**

☞**Service's Attacks on Identity Theft Proving Successful**

The IRS's efforts at combating individual tax identity theft are producing results due largely to anti-fraud measures that the IRS is using to filter out returns. For the 2023 filing season, the agency has been using 236 computer software filters to identify potential identity theft returns and prevent payment of fraudulent refunds. This compares to only 168 filters used for the 2022 filing season. As of March of this year, the IRS computers flagged 1.1 million individual returns with refunds totaling $6.3 billion for additional review as a result of those identity theft filters. Not all those returns will be confirmed as fraudulent after verifying the filer's identity, but a good number will. **(Misc.; Identity Theft)**

IRS Issues Guidance on Disclosure Rules for Spouses Who Filed Joint Returns and Then Divorced or Separated (IRS Memo SBSE-05-0419-0010)

The IRS's **Small Business/Self-employed (SBSE)** division has issued guidance to its employees on disclosing collection activities to taxpayers who filed joint returns, but are no longer married (or, who separated and no longer reside in the same household). After receiving a verbal or written request from a taxpayer (and verifying his or her identity), IRS employees may verbally disclose the following information: (1) whether the IRS has attempted to collect the deficiency from the other spouse; (2) the amount collected, if any, and the current collection status; and (3) if suspended, the reason for suspension. Nevertheless, IRS employees may *not* disclose the other spouse's location or telephone number; any information about the other spouse's employment, income, or assets; or the income level at which a currently not collectible account will be reactivated. **(Misc.; IRS Audits)**

☞**New Electronic Filing Requirement - Form 8300, Report of Cash Payments Over $10,000 (IR-2023-157)**

Starting Jan. 1, 2024, businesses are required to electronically file **Form 8300, Report of Cash Payments Over $10,000**, instead of filing a paper return. This new requirement stems from the **final regulations** amending e-filing rules for information returns, including **Forms 8300**.

Form 8300: Businesses that receive more than $10,000 in cash in a single transaction must report these to the U.S. government. Although many cash transactions are legitimate, information reported on **Forms 8300** is intended to help combat those individuals and businesses attempting to evade taxes, profit from the drug trade, engage in terrorist financing or conduct other criminal activities such as money laundering. The government insists that it can "often trace money from these illegal activities through payments reported on **Forms 8300** that are timely filed, complete and accurate."

<u>Electronic Filing</u>: The new requirement for e-filing **Forms 8300** applies to businesses mandated to e-file certain other information returns, such as **Forms 1099** series and **Forms W-2**. Electronic filing and communication options "will be simpler and will make it easier to interact with the IRS." Beginning with calendar year 2024, businesses must e-file all **Forms 8300** (and other certain types of information returns required to be filed in a given calendar year) if they are otherwise required to file *at least 10* information returns other than **Form 8300**.

> **<u>Example</u>:** If a business files five **Forms W-2** and five **Forms 1099-INT**, then the business must e-file *all* their information returns during the year, including any **Forms 8300**. However, if the business files *fewer than 10* information returns of *any* type, other than **Forms 8300**, then that business does *not* have to e-file the information returns and likewise is *not* required to e-file any **Forms 8300**. However, businesses *not* required to e-file may still choose to do so.

<u>Waivers</u>: A business may file a request for a waiver from electronically filing information returns "due to undue hardship." For more information businesses can refer to **<u>Form 8508</u>, Application for a Waiver from Electronic Filing of Information Returns**. If the IRS grants a waiver from e-filing *any* information return, that waiver *automatically* applies to all **Forms 8300** for the duration of the calendar year. Nevertheless, a business may *not* request a waiver from filing only **Forms 8300** electronically. The business must include the word "WAIVERaiver" on the center top of each **Form 8300 (Page 1)** when submitting a paper filed return in such instances. But, as stated above, if a business is required to file *fewer than 10* information returns, other than **Forms 8300**, during the calendar year, the business may file **Forms 8300** in paper form without requesting a waiver (or, putting this notation at the top of the form being submitted). Again, if a business files *less than 10* information returns, it can still choose to e-file the **Forms 8300** electronically if it chooses to do so.

<u>Exemptions</u>: If using the technology required to e-file "conflicts with a filer's religious beliefs," they are *automatically* exempt from filing **Form 8300** electronically. In such cases the filer must include the words "RELIGIOUS EXEMPTION" on the center top of each **Form 8300 (page 1)** when submitting the paper filed return.

<u>Late Returns</u>: A business must "self-identify late returns." A business is required file a late **Form 8300** in the *same* way as a timely filed **Form 8300** (i.e., either electronically or on paper). A business filing a late **Form 8300** electronically must include the word "LATE" in the "comments section" of the return. A business filing a late **Form 8300** on paper must write "LATE" on the center top of each **Form 8300 (page 1)**.

<u>Record Keeping</u>: A business must keep a copy of every **Form 8300** it files, as well as any supporting documentation and the required statement it sends to customers, for *five years* from the date filed. Filing electronically "will provide a confirmation that the form was filed." However, e-file confirmation e-mails alone do *not* meet this record keeping requirement. When e-filing, filers must also save an actual copy of the form prior to finalizing the form submission. They should associate the confirmation number with the saved copy. Prior to finalizing the form for submission, businesses should save a copy of the form electronically or print a copy of the form.

<u>E-filing Advantages</u>: According to the IRS, "many businesses have already found the free and secure e-filing system to be a more convenient and cost-effective way" when meeting the reporting deadline of just 15 days after a transaction. They get free email acknowledgment of receipt of the form when they e-file. Businesses can batch e-file their reports, which is especially helpful to those required to file many forms.

To file Forms 8300 electronically, a business must set up an account with the **Financial Crimes Enforcement Network's BSA E-Filing System**. The IRS also ensures that the privacy and security of all taxpayer data will be maintained. **(Misc.; Form 8300)**

Comment: For more information, interested businesses can call the **Bank Secrecy Act E-Filing Help Desk** at 866-346-9478 or email them at **BSAEFilingHelp@fincen.gov**. For more information about the **BSA E-Filing System**, businesses can complete a technical support request at **Self-Service Help Ticket**. The help desk is available Monday through Friday from 8 a.m. to 6 p.m. EST. For more detailed information about the reporting requirement, see **FS-2023-19**. The IRS has also created a video - **How to Complete Form 8300 - Part I, Part II**. The short video points out sections of **Form 8300** for which the IRS commonly finds mistakes and explains how to accurately complete those sections.

☞**Large Cash Transaction Reported on Form 8300 Source of IRS Audit Leads (Audit Report No. 2018-30-076)**

Individuals who engage in large cash deals can draw unwanted IRS attention since the Service receives many reports of cash transactions in excess of $10,000 from banks, casinos, car dealers, pawn shops and other businesses that tend to take in cash. Currency transaction reports on **Form 8300** are a source of audit leads in uncovering unreported income. For the period Oct. 2014 through Jan. 2018, field auditors assessed approximately $189 million in taxes, penalties and interest on nearly 3,000 **Form 8300** referrals. Nevertheless, the Treasury inspectors concluded in their report that "the IRS can do even more." **(Misc.; Form 8300)**

Comment: For businesses that are unsure of what triggers the filing of **Form 8300**, the IRS has a **reference guide** which instructs them on their filing obligations. Reporting is required *not* only when a customer pays over $10,000 cash at one time, but also for multiple cash payments within 24 hours that total more than $10,000.

☞**Guidance Issued on When $10,000+ Cash Transactions Must Be Reported (IR 2020-168)**

The IRS has presented a series of examples where a person might have to file **Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business**.

Background: Generally, any person in a trade or business who receives more than $10,000 in cash in a single transaction or in related transactions must file a **Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business**. A "person" is an individual, company, corporation, partnership, association, trust or estate. Furthermore, a person must file **Form 8300** if they receive cash of more than $10,000 from the same payer or agent:

- In one lump sum;

- In two or more related payments within 24 hours (e.g., a 24-hour period is 11 a.m. Tuesday to 11 a.m. Wednesday); or

- As part of a single transaction or two or more related transactions within a 12-month period.

Reporting Situation Examples: This IRS release contains the following examples of reporting situations:

- New or used automobile dealers: If a husband and wife purchased two vehicles at one time from the same dealer, and the dealer received a total of $10,200 in cash, the dealer can *either* view the transaction as a single transaction or two related transactions. Either way, the dealer needs to file only *one* **Form 8300**. But the dealership does need *not* to file **Form 8300** if a customer pays with a $7,000 wire transfer and a $4,000 cashier check since a wire transfer is *not* considered to be the same as tendering cash.

Suppose a customer purchases a vehicle for $9,000 cash. Within 12 months, the customer pays the dealership cash of $1,500 for accessories for that vehicle. The dealer does *not* need to file **Form 8300** unless the accessories purchase was related to the original vehicle purchase.

- Taxi company: When lease payments made in cash by a taxi driver to a taxi company within a 12-month period exceed $10,000 in total, the taxi company needs to file **Form 8300**. Then, if the company receives more than $10,000 cash in additional payments from the driver, the company must file another **Form 8300**.

- Landlords: The 12-month period also applies to landlords who need to file **Form 8300** once they have received more than $10,000 in cash for a specific lease during the year. But, if a person uses a dwelling unit as a home and rents it less than 15 days during the year, its primary function is *not* considered rental in a trade or business, so they do *not* need to report a cash receipt of more than $10,000.

> **Comment:** Milwaukee was supposed to host both have the Democratic National Convention and the Ryder Cup this summer. And, especially for larger, more conveniently located homes, the rent can be over $20,000 for 14 days (or, less). But based on the rule mentioned above, there would be no **Form 8300** reporting requirement.

- Bail-bonding agent: A bail-bonding agent must file **Form 8300** when they receive more than $10,000 in cash from any one person. This applies to payments from persons who have been arrested or anticipate arrest. The agent needs to file the form even though he has *not* provided a service when they received the cash.

- Colleges and universities: Colleges and universities must file **Form 8300** if they receive more than $10,000 in cash in one or more transactions within 12 months. A **Form 8300** exception applies for government entities but *not* for educational entities.

- Contractors: Contractors must file **Form 8300** if they receive cash of more than $10,000 for building, renovating, remodeling, landscaping, and painting. **(Misc.; Form 8300)**

☞**Failure to Inform IRS of Address Change Costs Taxpayer (*Gregory*, 152 TC No. 7 (3/13/2019))**

In situations where the taxpayer has an outstanding liability, the IRS is required to send a notice of deficiency by certified or registered mail to the taxpayer's last known address before assessing a amount due or beginning collection proceedings. Actual receipt by the taxpayer of the notice is immaterial. In this instance, a married couple who moved never received the deficiency notice because the Service sent it to the address on their most recently filed **Form 1040** and *not* to the new address. Nevertheless, the couple insisted that the IRS was notified of the address change because of their filing of a power of attorney (i.e., in **Form 2848**), as well as by their filing an extension for filing their return on **Form 4868**. The Tax Court sided with the Service that these alternative means "did *not* supplant the need to formally file **Form 8822**, **Change of Address**." **(Misc.; Change of Address)**

☞**IRS Not Responsible for Preparer Stealing Client's Tax Refund (*Prosper*, 131 AFTR2d 2023 (D.C., Ind.))**

The preparer of the taxpayer's return stole her tax refund. She then petitioned the court to have the IRS issue another refund to her. The woman asked a family friend with tax expertise to prepare and file her **Form 1040**. The IRS properly deposited the refund into a bank account that was listed on the tax return. The taxpayer, however, claimed that she never had such an account and that the preparer opened it in order to steal the refund. The district court dismissed the case since the IRS followed the rules when it sent the refund to the account that was listed on the *signed* return, and the funds were received in the account. It agreed that the Service has no obligation to reissue the refund to the woman. **(Misc.; Tax Refunds)**

> **Comment:** This only demonstrates the point that when a client signs a return they should at least do a review for obvious mistakes even though they might not otherwise understand the inherent complexities of the tax law.

☞**Preparers Not Allowed to Divert Part of Client Refunds to Their Own Bank Accounts (*Narayan*, No. 19-442T (Ct. of Fed. Claims, 9/5/2019))**

When a client has a tax refund coming, **Form 8888** is used to direct where the funds should go when they are being allocated to more than one account in a taxpayer's name. Tax return preparers, however, are *not* permitted to use it to have their fee paid from a filer's refund. In this instance, the taxpayer agreed to pay his preparer's fee out of his refund and attached the **Form 8888** listing two accounts for deposit, one in his name and one belonging to the preparer. But, after the IRS deposited the entire amount of the refund solely in the taxpayer's account, the preparer sued the IRS when he was not paid his $240 fee. The federal court here dismissed the case, stating that the preparer's dispute is with the client and *not* with the Revenue Service. **(Misc.; Form 8888)**

> **Comment:** The instructions to **Form 8888** specifically state "Account must be in your name. Don't request a deposit of your refund to an account that isn't in your name, such as your tax return preparer's account. Although you may owe your tax return preparer a fee for preparing your return, don't have any part of your refund deposited into your preparer's account to pay the fee."

☞**What Tax Professionals Should Do after a Data Theft or Loss (Tax Tip 2021-145)**

If a tax professional or their firm is the victim of data or information theft, they must deal with it "thoroughly and efficiently." Here are some actions they should take immediately to help minimize damage and protect against future data and theft or losses.

Contact the IRS and law enforcement

- **Internal Revenue Service:** The tax preparer should report client data theft to their local **IRS Stakeholder Liaison**. In turn, the Stakeholder Liaison will notify **IRS Criminal Investigation** and others within the agency on the tax professional's behalf. Speed is critical. If reported quickly, the IRS can take steps to block fraudulent returns in clients' names.

- **Federal Bureau of Investigation or the United States Secret Service:** The preparer should contact a local office of either the FBI or the USSS.

- **Local police:** The taxpayer should contact police to file a report on the data breach.

Contact states in which the tax professional prepares state returns

- Any breach of personal information could have an adverse effect on the victim's tax accounts with the states as well as the IRS. To help tax professionals find where to report data security incidents at the state level, the **Federation of Tax Administrators** has created a special page with state-by-state **listings**.

- The preparer should contact the State Attorneys General for each state in which the tax professional prepares returns.

Contact experts

- **Security expert:** Tax preparers should consult an expert who can help determine the cause and scope of the breach, to stop the breach, and to prevent further breaches from occurring.

- **Insurance company:** The preparer should report the breach to their insurance company and to check if the insurance policy covers data breach mitigation expenses.

- **Federal Trade Commission:** Preparers and other businesses can go to the FTC for guidance. For more individualized guidance, preparers can contact the **FTC**.

- **Credit and identity theft protection agency:** Certain states require that preparers offer credit monitoring and ID theft protection to victims of ID theft.

- **Credit bureaus:** Preparers should notify them if there is a compromise and clients may seek their services.

Contact clients

- Preparers should send an individual letter to all victims to inform them of the breach, but they should work with law enforcement on when to send the letter. **(Misc.; Data Theft)**

☞**IRS Unveils Client Data Security Plan for Tax Professionals**

The Security Summit partners have unveiled a "special new sample security plan" designed to help tax professionals, especially those with *smaller* practices, protect their clients' data and information. The special plan, called a **Written Information Security Plan (WISP)**, is outlined in a 29-page **document** that has been worked on by members of the Security Summit, including tax professionals, software and industry partners, representatives from state tax groups and the IRS. Below is a summary of their suggestions and observations.

> **Comment:** One suggestion is to use this written template of a data security plan as a starting point and then modify it to fit your particular practice.

> **Comment:** To get a preparer tax ID number, new applicants and renewals must check a box to confirm that they are aware of their responsibilities in protecting client data.

Federal law requires *all* professional tax preparers "to create and implement a data security plan." The Security Summit group which is a public-private partnership between the IRS, states and the nation's tax industry "has noticed that some tax professionals continue to struggle with developing a written security plan." In response to this need, the Summit (led by the **Tax Professionals Working Group**) has spent months developing a "special sample document that allows tax professionals to quickly set their focus in developing their own written security plans."

"Tax professionals play a critical role in our nation's tax system," said Carol Campbell, director of the **IRS Return Preparer Office** and co-lead of the Summit tax professional group. "But for many tax professionals, it is difficult to know where to start when developing a security plan. The Summit members worked together on this guide to walk tax pros through the many considerations needed to create a **Written Information Security Plan** to protect their businesses and their clients, as well as comply with federal law."

> **Comment:** Each year, the Security Summit partners highlight a **"Protect Your Clients; Protect Yourself"** summer campaign aimed at tax professionals. This is the fourth in a series of five tips for this year's effort. These are issued each Tuesday to coincide with the Nationwide Tax Forums, which help educate tax professionals on security and other important topics.

The Summit leaders stated that "There are many aspects to running a successful business in the tax preparation industry, including reviewing tax law changes, learning software updates and managing and training staff. One often overlooked but critical component is creating a WISP."

"There's no way around it for anyone running a tax business. Having a written security plan is a sound business practice and it's required by law," said Jared Ballew of Drake Software, co-lead for the Summit tax professional team and incoming chair of the **Electronic Tax Administration Advisory Committee (ETAAC)**. "The sample document provides a starting point for developing your plan, addresses risk considerations for inclusion in an effective plan and provides a blueprint of applicable actions in the event of a security incident, data losses and theft."

Security issues for a tax professional can be daunting. As a result, the Summit team "worked to make this document as easy to use as possible, including special sections to help tax professionals get to the information they need." "We have tried to stay away from complex jargon and phrases so that the document can have meaning to a larger section of the tax professional community," said Campbell. "It is not intended to be the final word in **Written Information Security Plans**, but it is intended to give tax professionals a place to start in understanding and attempting to draft a plan for their business."

The Summit went on to state that "A security plan should be appropriate to the company's size, scope of activities, complexity and the sensitivity of the customer data it handles. There is no one-size-fits-all WISP. For example, a sole practitioner can use a more abbreviated and simplified plan than a 10-partner accounting firm, which is reflected in the new sample WISP from the Security Summit group."

Once completed, tax professionals should keep their WISP in a format that others can easily read, such as .PDF or Word. Making the WISP available to employees for training purposes is encouraged. Storing a copy offsite or in the cloud is a recommended best practice in the event of a natural disaster.

There are additional resources that the Summit suggested that tax practices take a look at as follows:

- Tax professionals also can get help with security recommendations by reviewing **IRS Pub. 4557, Safeguarding Taxpayer Data, and Small Business Information Security: The Fundamentals by the National Institute of Standards and Technology**. The **IRS Identity Theft Central** pages for tax pros, individuals and businesses have important details as well.

- **IRS Pub. 5293, Data Security Resource Guide for Tax Professionals**, provides a compilation of data theft information available on **IRS.gov**. Also, tax professionals should stay connected to the IRS through subscriptions to **e-News for Tax Professionals** and social media.

- The IRS also recommends tax professionals create a "data theft response plan," which includes contacting the **IRS Stakeholder Liaisons** to report a theft. **(Misc.; Client Records)**

> **Comment:** The **Gramm-Leach-Bliley Act** (GLBA) requires *all* professional tax preparers to create and implement a data security plan.

Comment: Preparers and other tax professionals are at risk from phishing scams. Cyberthieves are increasingly targeting them in their attempts to get at client records and sensitive data. Furthermore, these crooks are becoming much more sophisticated in what they're looking for. As discussed above, the IRS offers steps to help tax professionals safeguard their data, as well as that of their clients. Among the various suggestions are the following: (1) Use strong passwords with multi-factor authentication; (2) Install anti-virus security software on electronic devices with automatic updates; (3) Use drive encryption on e-mails to clients and back up electronic taxpayer data; and (4) Encourage clients to sign up for identity-protection personal identification numbers.

Comment: Here are specific steps preparers should take if a client data theft occurs: (1) Report it to your local IRS stakeholder liaison, the **Federation of Tax Administrators** and police; (2) Contact credit bureaus; (3) Hire a security expert to discover the source of the breach and explain how to prevent further mishaps; (4) Call your insurance agent to see if your policy covers data breach mitigation expenses; and (5) Be sure to send an individual letter to each client, notifying them of the breach.

Code §41 - R&D Credit:

IRS Issues Guidance on Amortization of R&D Expenses (Notice 2023-63)

The IRS has released new guidance which focuses on the amortization of "specified research or experimental" (SRE) spending under **Code §174**. The Service also plans to issue proposed regulations addressing SRE expenditures "that will be consistent with what is outlined in this notice." These new regs are expected to apply to tax years ending *after* 9/8/23. But before the proposed regulations are released, a taxpayer may choose to rely on **Notice 2023-63**, except for the rules in **Sec. 7**, so long as the taxpayer "relies on all rules and applies them consistently." **Notice 2023-63** also addresses how to account for SRE expenses under **Code §460** and how to apply **Code §482** to cost-sharing agreements involving SRE expenditures. Additionally, the IRS has indicated the **Code §460** regulations will likely be revised to reflect these updates. **(Code §174; R&D Expenses)**

Comment: Congress could still act to restore treating R&D expenses as a tax credit. But, for now, the law requires such costs to be capitalized and amortized over 5 years.

Code §44 - Disability Access Credit:

☞Qualifying for Disability Access Credit

Businesses that make their premises disability-accessible are entitled to two separate potential tax breaks. First, the disabled access credit is for businesses with incomes of $1 million or less, or that otherwise employed no more than 30 full-time employees during the previous tax year. The key is that the costs incurred must enable the business to comply with the **Americans with Disabilities Act**. The maximum annual credit is $5,000 with the first $250 of eligible expenses being ignored, and the next $10,000 of such costs qualifying for a 50% credit. **Form 8826** is used to claim the credit. In addition, the "barrier removal tax deduction" permits businesses of any size to write off a portion of the cost of removing architectural and transportation barriers to help people with disabilities and the elderly get around more easily. Normally, the business would be required to capitalize the full cost of these improvements, but the law allows them to immediately expense as much as $15,000 of the total cost. Finally, a qualifying business can claim *both* of these breaks in the same tax year. **(Code §44; Disabled Access Credit)**

Code §162 - Business Expenses:

☞**Tax Rules for Deducting Business Travel Expenses**

Many people travel for their job - some for an occasional conference and some travel year-round. Whatever their time on the road, business travelers should know how and when to deduct business travel expenses. And, the IRS has put together a good **summary** of these rules.

Comment: This issue is coming up a bit more today with employees working remotely for the most part and only going into the office one or two days each week. Nevertheless, it does not change nondeductible commuting expenses into tax deductible travel costs. And if an employer were to now reimburse them under an accountable plan (or, any other arrangement), it should simply be treated as additional W-2 wages.

Comment: Another issue that we should not overlook is that of the "turtle rule" which deals with truckers who are often out on the road for weeks at a time sleeping in their cabs at random travel plazas on a daily basis. To claim deductible travel expenses, though, for tax purposes a trucker must have a tax home in a real and substantial sense. A trucker that fails to meet these criterion is considered a "tax turtle," an itinerant or someone who has a home wherever they happen to be working.

Tax Deductions for Business Travel: Business travel deductions for tax purposes are available for certain people who "travel away from their home or main place of work for business reasons." A taxpayer is considered to be "traveling away from home" if they are away for longer than an ordinary day's work and they need to sleep in a location other than their home to meet the demands of their work while away. Also, travel expenses must be "ordinary and necessary." They cannot be "lavish, extravagant or for personal purposes." Employers can deduct travel expenses paid or incurred during a "temporary work assignment" if the assignment is expected to last for 12 months or less (i.e., it is *not* anticipated to be indefinite as of the time that the travel for that job assignment commences). Travel expenses for conventions are deductible if attending them benefits the business. However, there are special rules for conventions held outside of North America

Comment: This issue of trying to take travel expenses while on what appears to be an indefinite job assignment is one that the IRS continues to take to court. In a number of instances, the taxpayer decides to live in FL, for example, yet they "commute" to a distant worksite or job assignment on a weekly basis. They are free to live wherever they want, but the IRS is *not* going to allow what would be "commuting expenses" into deductible "travel expenses."

Deductible travel expenses include:

- Travel by plane, train, bus or car between home and a business destination

- Fares for taxis or other types of transportation between an airport or train station and a hotel, or from a hotel to a work location

- Shipping of baggage and sample or display material between regular and temporary work locations

- Using a personally owned car for business

- Lodging and meals

- Dry cleaning and laundry

- Business calls and communication

- Tips paid for services related to any of these expenses

- Other similar ordinary and necessary expenses related to the business travel

Comment: Taxpayers can find more about the rules for travel deductions with **IRS Pub. 463, Travel, Gift, and Car Expenses**.

Proprietors with Travel Deductions: Self-employed individuals are permitted to deduct travel expenses on **Schedule C**, whereas agricultural and horticultural business owners can deduct travel expenses on **Schedule F**.

Travel Deductions for Armed Forces Reservists: Members of a reserve component of the Armed Forces of the United States can claim a deduction for unreimbursed travel expenses paid during the performance of their duty. However, these travel expenses must be for travel more than 100 miles away from their home.

Comment: It is not unusual for an Army reservist or National Guardsman to go away for a few weeks each summer for training purposes. This is where such unreimbursed travel expenses can be deducted on **Form 2106** which then flows to **Schedule 1** and finally to **Page 1** of **Form 1040, Line 10** as adjustments in arriving at the taxpayer's AGI.

Importance of Good Recordkeeping: It is easier to prepare a tax return with **organized records**. Therefore, taxpayers should keep records such as receipts, canceled checks and other documents that support a deduction. **(Code §162; Travel Expenses)**

☞**Clarity Needed on Travel Expenses for Remote Workers**

The AICPA is asking both IRS and Treasury officials for updated guidance on remote working arrangements, especially with regard to travel reimbursements. Specifically, the issue of deductibility of travel expenses by employees often depends on whether they are "physically present in an employer-provided work space." For example, how should an employee be reimbursed for expenses incurred in traveling to an "employer-provided work location" when travel days are limited and the distance has increased over what would have been their normal commute. The AICPA maintains that its analysis of new scenarios involving various work arrangements (e.g., employer location-based, remote, and hybrid) had concluded that "current revenue rulings and interpretations of case law are outdated, do *not* reflect the current work environment, and are unclear in many instances." Furthermore, "The lack of updated guidance has left employers and employees in the untenable position of making decisions regarding employer workplace policies while the rules regarding amounts reported as payments, to or for the benefit of employees, remain uncertain." In many modern working arrangements, both the employer and the employee considered the latter's residence as the main site at which work is performed. As a result, "In many instances, existing tax guidance does *not* apply to today's work arrangements to determine when expenses are deductible travel expenses and when such amounts are non-deductible commuting expenses."

A major recommendation is that the Treasury and the IRS revise **Rev. Rul. 99-7** to eliminate its reference to the "exclusive use" requirement under **Code §280A(c)** while also reflecting "modern work arrangements." In addition, the concept of "for the convenience of employer" should be updated. One alternative would be to establish a "safe harbor" to be used in determining a "principal place of business" with specific criteria that would no longer refer to the "exclusive use" requirement of **Code §280A(c)**.

Another issue is whether employers should be reassessing their fringe benefit programs in response to employees' questions about remote working arrangements. These include whether days spent in an employer-provided office are "travel days" on which remote workers could be reimbursed for their expenses. Because many employers have set policies and positions "based on reasonable interpretations of existing guidance," new guidance should be issued that takes into account any transition relief employers would need to facilitate compliance. **(Code §162; Remote Workers)**

☞**Remote Workers Claiming Home Office Deduction**

With an estimated 10% percent or more of the current workforce operating fully remote these days, a common issue is whether a home office deduction can be claimed. Under **Code §280A(c)(6)** employees are *not* permitted to take this deduction. Prior to 2018 and the **TCJA**, certain employees were allowed to deduct the cost of home office expenses as unreimbursed employee costs (i.e., as 2% miscellaneous itemized deductions via **Form 2106** and **Schedule A**).

> **Comment:** One possible planning tip might be *not* having to take a deduction for these unreimbursed home office expenses. For example, suppose the taxpayer had their S corporation tax consulting practice based out of their home with a lease arrangement for so much rent to be paid each month along with a "reimbursement clause." If the office occupied 10% of the square footage of home, then the "employer" S corp would reimburse, for instance, that percentage of the insurance, utilities, etc. As a result, the "employee" in this situation has no need to deduct any expenses allocable to the home office on their personal return.

The deduction is certainly available to self-employed people or independent contractors who use a room or some other dedicated space in their home "exclusively and regularly" as their "principal place of business." Both homeowners and renters can claim this tax deduction.

There are two possible methods when calculating the home office deduction as follows:

- Allocate the actual costs, including utilities and home owners insurance, as well as depreciation or a portion of your rent (i.e., if you do *not* own the home), on **Form 8829**.

- Use the "simplified option" where you get to deduct $5 per square foot of space used exclusively for business, up to 300 square feet (i.e., for a $1,500 maximum deduction). Under this option, depreciation is treated as zero, so your cost basis in the home will *not* be reduced and will therefore *not* impact the gain for tax purposes when you eventually sell (and, seek to claim the home sale exclusion of $250,000 or $500,000). **(Code §162; Home Office)**

☞**Service Issues Proposed "Reliance Regs" on Personal Use of Employer-Provided Vehicles (REG-101378-19)**

The IRS has issued proposed regs, on which taxpayers may rely until the publication of final regs, regarding special valuation rules for employers and employees to use in determining the amount to include in an employee's gross income for personal use of an employer-provided vehicle.

> **Comment:** One of the more salient developments discussed in these regs will be the *significant increase* with regard to the "cents-per-mile method" when it comes time to quantify the personal use of a company car in an employee's W-2. Previously, this method could only be used when the FMV of the car was $12,800 or below. Now, it will be available for vehicles with a value of up to $50,000. As a result, we will *not* have to depend on using the "annual lease value method" nearly as much.

> **Background - Employer-provided Vehicles:** Generally speaking, if an employer provides an

employee with a vehicle that is also available to the employee for personal use, the value of the personal use must be included in the employee's income under **Code §61** (i.e., as additional gross income). This benefit is treated as additional remuneration for employment which would be wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA) and federal income tax withholding. (**Code §3121(a)**, **Code §3306(b)**, and **Code §3401(a)**)

Background - Vehicle Cents-per-mile Rule: For employer-provided vehicles made available to employees for personal use that meet the requirements of **Reg. §1.61-21(e)(1)**, generally the value of the personal use may be determined under the vehicle cents-per-mile valuation rule of **Reg. §1.61-21(e)**. However, **Reg. §1.61-21(e)(1)(iii)** previously provided that the value of the personal use could *not* be determined under the vehicle cents-per-mile valuation rule for a calendar year if the fair market value of the vehicle on the first date the vehicle was made available to the employee exceeded a base value of $12,800 that was adjusted annually under **Code §280F(d)(7)**.

Reg. §1.61-21(e)(5)(i) states that an employer must adopt the vehicle cents-per-mile valuation rule by the first day on which the vehicle is used by an employee of the employer for personal use (or, if the commuting valuation rule of **Reg. §1.61-21(f)** is used when the vehicle is first used by an employee of the employer for personal use and the employer switches to the vehicle cents-per-mile valuation rule, the first day on which the commuting valuation rule is *not* used). **Reg. §1.61-21(e)(5)(ii)** provides that once the vehicle cents-per-mile valuation rule has been adopted for a vehicle by an employer, the rule must be used by the employer for *all* subsequent years in which the vehicle qualifies for use of the rule, except that the employer may, for any year during which use of the vehicle qualifies for the commuting valuation rule of **Reg. §1.61-21(f)**, instead use the commuting valuation rule with respect to the vehicle.

Background - Fleet-average Valuation Rule: For employer-provided automobiles available to employees for personal use for an *entire* year, generally the value of the personal use may be determined under the "automobile lease valuation rule" of **Reg. §1.61-21(d)**. Provided the requirements of **Reg. §1.61-21(d)(5)(v)** are met, an employer with a fleet of *20 or more* automobiles may use a fleet-average value for purposes of calculating the annual lease values of the automobiles in the employer's fleet. However, **Reg. §1.61-21(d)(5)(v)(D)** provides that the value of an employee's personal use of an automobile may *not* be determined under the fleet-average valuation rule for a calendar year if the fair market value of the automobile on the first date the automobile is made available to an employee exceeds the base value of $16,500, as adjusted annually for inflation pursuant to **Code §280F(d)(7)**.

Background - TCJA Changes: The **Tax Cuts and Jobs Act** *significantly increased* the maximum dollar limitations on the depreciation deductions for passenger automobiles under **Code §280F(a)** and also changed the way that inflation increases are calculated.

Background - Notice 2019-8: **Notice 2019-8** states that, consistent with the substantial increase in the dollar limitations on depreciation deductions under **Code §280F(a)**, as modified by the **TCJA**, the IRS intends to amend **Reg. §1.61-21(d)** and **Reg. §1.61-21(e)** to incorporate a *higher base value of $50,000* as the maximum value for use of the vehicle cents-per-mile and fleet-average valuation rules *effective for the 2018 calendar year*. **Notice 2019-8** also provides that, for 2018, the maximum value for use of *both* the vehicle cents-per-mile and fleet-average valuation rules is $50,000 (i.e., up from $12,800 and $16,500, respectively).

Background - Notice 2019-34: This new IRS Notice provides various rules, including:

a. Rules that provide relief to taxpayers with respect to the above-mentioned regs that were *not* updated to reflect the TCJA's increase in the limitations on permitted depreciation for automobiles; and

b. The method of publishing maximum vehicle value in the future.

These proposed regs serve to formalize and explain earlier IRS Notices by updating the fleet-average and vehicle cents-per-mile valuation rules described in **Reg. §1.61-21(d)** and **Reg. §1.61-21(e)**, respectively, to align the limitations on the maximum vehicle fair market values for use of these special valuation rules with the changes made by the TCJA to the depreciation limitations in **Code §280F**. Consistent with the *substantial increase in the dollar limitations* on depreciation deductions under **Code §280F(a)**, the proposed regs increase, effective for the **2018 calendar year**, the maximum base fair market value of a vehicle for use of the fleet-average or vehicle cents-per-mile valuation rule to $50,000. Furthermore, the maximum fair market value of a vehicle for purposes of the fleet-average and vehicle cents-per-mile valuation rule will be adjusted annually for inflation under **Code §280F(d)(7)**.

The proposed regs provide the following rules that are consistent with rules contained in **Notice 2019-34**:

- With respect to the vehicle cents-per-mile valuation rule, the regs provide the following rule for a vehicle first made available to any employee of the employer for personal use ***before* calendar year 2018**. If an employer did *not* qualify under **Reg. §1.61-21(e)(5)** to adopt the vehicle cents-per-mile valuation rule on the first day on which the vehicle was used by the employee for personal use because the fair market value of the vehicle exceeded the inflation-adjusted limitation of **Reg. §1.61-21(e)(1)(iii)**, the employer may first adopt the vehicle cents-per-mile valuation rule ***for the 2018 or 2019 taxable year*** with respect to the vehicle, provided the fair market value of the vehicle does *not* exceed $50,000 on January 1, 2018, or $50,400 on January 1, 2019, respectively. (**Prop. Reg. §1.61-21(e)(5)(vi)**)

The regs provide a similar rule if the "commuting valuation rule" of **Reg. §1.61-21(f)** was utilized when the vehicle was first used by an employee of the employer for personal use, and the employer did *not* qualify to switch to the vehicle cents-per-mile valuation rule on the first day on which the commuting valuation rule was *not* used because the vehicle had a fair market value in excess of the inflation-adjusted limitation (i.e., $12,800) of **Reg. §1.61-21(e)(1)(iii)**. In that case, the employer will be permitted to adopt the vehicle cents-per-mile valuation rule ***for the 2018 or 2019 taxable year***, provided the fair market value of the vehicle does *not* exceed $50,000 on January 1, 2018, or $50,400 on January 1, 2019, respectively. However, consistent with **Reg. §1.61-21(e)(5)**, an employer that adopts the vehicle *cents-per-mile valuation rule* must continue to use the rule for *all* subsequent years in which the vehicle qualifies for use of the rule, except that the employer may, for any year during which use of the vehicle qualifies for the *commuting valuation rule* of **Reg. §1.61-21(f)**, use the commuting valuation rule with respect to the vehicle. (**Prop. Reg. §1.61-21(e)(5)(vi)**) **(Code §61; Company Vehicles)**

> **Comment:** The "commuting valuation rule" (i.e., $1.50 commuting each way per day, or $7.50 for a typical work week) is only available when a company (perhaps for security reasons not wanting the vehicle parked at the business location overnight) instructs the employee to use it only to commute back and forth to work. But, it appears that a "control employee" (i.e., one owner 5% or more of the company) will *not* be allowed to use this method (even if that is supposedly all the company is used for).
>
> **Comment:** Although it might be simpler to continue using the "annual lease value" rule to calculate the personal use portion of a company car in order to impute the value of any personal v. business use in the employee's W-2, this amount should be compared to using the IRS current $.58¢/mile rule (i.e., for the 2019 tax year under the cents-per-mile method) for any personal use miles driven by the employee and see which one give a lesser amount before doing any switch-over (i.e., since you are locked in once you make the change in methods).

☞**Special Valuation Rules for Employer-provided Automobiles (Notice 2023-03)**

Notice 2023-03 highlights the amount that must be included in the employee's income and wages for the *personal* use of an employer-provided automobile and is generally determined by reference to the automobile's FMV. Under **Reg. §1.61-21(b)(4),** if an employer chooses to use a special valuation rule, the special value is treated as the FMV of the benefit for income tax and employment tax purposes. Two such special valuation rules, the fleet-average valuation rule and the vehicle cents-per-mile valuation rule, are set forth in **Reg. §1.61-21(d)(5)(v)** and **Reg. §1.61-21(e)**, respectively. These two special valuation rules are subject to limitations, including that they may be used only in connection with automobiles having values that do *not* exceed a maximum amount set forth in the regulations.

Comment: This IRS Notice also contains the optional 2023 standard mileage rates, as well as the maximum automobile cost used to calculate the allowance under a fixed and variable rate (FAVR) plan. **(Code §162; Standard Mileage Rates)**

☞**Updated Per Diem Amounts Announced (Notice 2023-68)**

Notice 2023-68 lists the updated per diem rates effective October 1, 2023, which taxpayers may use to substantiate the amount of expenses for lodging, meals, and incidental expenses when traveling away from one's "tax home." This notice also provides the special transportation industry rate, the rate for the incidental expenses only deduction, and the rates and list of high-cost localities for purposes of the high-low substantiation method.

Rev. Proc. 2019-48: This IRS procedure provides the rules for using per diem rates, rather than actual expenses, to substantiate the amount of expenses for lodging, meals, and incidental expenses for travel away from home. Taxpayers who use per diem rates to substantiate the amount of travel expenses under **Rev. Proc. 2019-48** may use the federal per diem rates published annually by the General Services Administration. **Rev. Proc. 2019-48** allows certain taxpayers to use a special transportation industry rate or to use rates under a high-low substantiation method for certain high-cost localities. The IRS announces these rates and the rate for the incidental expenses only deduction in an annual notice. Use of a per diem substantiation method, however, is *not* mandatory. A taxpayer may instead choose to substantiate *actual* allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation.

New Per Diem Rates: The Meal and Incidental Expense (M&IE) rates for the transportation industry are $69 for travel in the continental U.S. and $74 for travel outside the continental U.S. The per diem for travel to high-cost localities has increased from $297 to $309 ($74 for M&IE), while the rate for travel to other localities has increased from $204 to $214 ($64 for M&IE). The incidental-expenses-only rate remains at $5 per day. The updated rates and list of high-cost locations apply to per diem allowances paid to employees *after* 9/30/23. **(Code §274; Per Diem Rates)**

☞**Service Offers Guidance on Taxation of Per Diem Reimbursements (Info Ltr 2019-0003)**

In this recent Information Letter, the IRS was asked to consider a waiver (or, other action) on the taxation of per diem reimbursements for employees and contractors. The agency declined to act, explaining that it would be necessary for Congress to take legislative action to change the current rules. But, generally speaking, per diem reimbursements are *not* taxable if the taxpayer is "away from home on a temporary work assignment." If the employee is assigned to *a single* location that is *not* his or her regular work location, and the assignment is realistically expected to last (and does in fact last) for one year or less, the assignment is considered to be "temporary" for income tax purposes. On the other hand, if an assignment away from home in a single location is expected to last for *more than one year*, the assignment is "indefinite and *not* temporary," regardless of whether or not it does in fact exceed one year, with the end result that any per diem arrangement for reimbursement of travel expenses being treated as additional wages to the employee. **(Code §162; Per Diem Reimbursements)**

☞**IRS Issues Updated Per Diem Rates (Notice 2022-44)**

These updated special per diem rates are effective October 1, 2022 and allow taxpayers to use them to substantiate the amount of expenses for lodging, meals, and incidental expenses when traveling away from home. This notice also provides the special transportation industry rate, the rate for the incidental expenses only deduction, and the rates and list of high-cost localities for purposes of the high-low substantiation method. **(Code §162; Per Diem Rates)**

> **Comment:** Use of a per diem substantiation method is *not* mandatory. Instead, taxpayers are permitted to substantiate actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. But these updated rates and list of high-cost locations apply to per diem allowances paid to employees *after* 9/30/22 (although taxpayers can opt to use the old per diem rates for the remainder of 2022 if they want).

The Meal and Incidental Expense (M&IE) rates for the transportation industry are $69 for travel in the continental U.S. and $74 for travel outside the continental U.S. The per diem for travel to high-cost localities has increased from $296 to $297 ($74 for M&IE), while the rate for travel to other localities has increased from $202 to $204 ($64 for M&IE). The incidental-expenses-only rate remains at $5 per day.

☞**IRS Releases Standard Mileage Rates for 2023 (IR-2022-234)**

The IRS has issued the 2023 optional standard mileage rates used to calculate the deductible costs of operating an automobile for business, charitable, medical or moving purposes. Beginning on Jan. 1, 2023, the standard mileage rates for the use of a car (also vans, pickups or panel trucks) will be:

- 65.5 cents per mile driven for business use, up 3 cents from the mid-year increase setting the rate for the second half of 2022 at 52.5 cents per mile

- 22 cents per mile driven for medical or moving purposes for qualified active-duty members of the Armed Forces, consistent with the increased midyear rate set for the second half of 2022

- 14 cents per mile driven in service of charitable organizations (the rate is set by statute and remains unchanged from 2022)

These rates apply to electric and hybrid-electric automobiles, as well as gasoline and diesel-powered vehicles. The standard mileage rate for business use is based on an annual study of the *fixed and variable costs* of operating an automobile. The rate for medical and moving purposes is based solely on the *variable* costs.

> **Comment:** Keep in mind that under the **Tax Cuts and Jobs Act**, taxpayers cannot claim a 2% miscellaneous itemized deduction for unreimbursed employee travel expenses (i.e., on **Form 2106**). Taxpayers also cannot claim a deduction for moving expenses (i.e., on **Form 3903**), unless they are members of the Armed Forces "on active duty moving under orders to a permanent change of station."

Taxpayers always have the option of calculating the *actual* costs of using their vehicle rather than using the standard mileage rates. Taxpayers can use the standard mileage rate but generally must opt to use it in the *first* year the car is available for business use. Then, in later years, taxpayers can choose *either* the standard mileage rate or actual expenses. Leased vehicles must use the standard mileage rate method for the *entire* lease period (including renewals) if the standard mileage rate is initially chosen.

Mileage Rate Cannot Be Combined with Claiming Actual Expenses on Business Vehicles (*Eldred*, TC Summ. Op. 2018-49 (10/4/2018))

This case serves as a reminder for taxpayers using their vehicles for business purposes and who also use the IRS's standard mileage rates for claiming any associated expenses. In such instances, the taxpayer is *not* permitted to also depreciate or expense the vehicle. Likewise, they cannot claim write-offs for actual expenses incurred, such as for car repairs, insurance, gasoline, etc. The IRS is cracking down on taxpayers attempting to do this "dual approach." Here, a couple deducted vehicle expenses on Schedule C using the optional standard mileage allowance, while also claiming depreciation deductions and Section 179 expensing on the same automobile. The IRS selected their return for audit and allowed only expenses based on mileage rates which the Tax Court upheld. **(Code §162; Vehicle Expenses)**

Comment: However, parking and tolls may be added to the total expense amount calculated using the standard mileage rate.

IRS Provides Updated SIFL Rates for Second Half of 2023 (Rev. Rul. 2023-19)

The IRS has provided information for use in determining the value of non-commercial flights on employer-provided aircraft under **Reg. §1.61-21(g)** for the second half of 2023. Employer-provided flights are valued using the cents-per-mile rates and terminal fees from the Standard Industry Fare Level (SIFL), which is updated semi-annually. From 7/1/23 through 12/31/23, the terminal charge rate is $52.98, up from $52.35 for the first half of 2023. The SIFL standard mileage rates for the second half of 2023 are as follows: $0.2898 for up to 500 miles, $0.2210 for miles between 501 and 1,500, and $0.2124 for miles greater than 1,500. **(Code §61; SIFL)**

Comment: Just as with the personal use of a company car, the value of any personal use of the company's airplane by an employee must calculated and included in their W-2. But, unlike the situation with a company car where the imputation of the value of any personal use by an employee "restores the business/investment use" back up to 100%, this is *not* the case with a company airplane. Pursuant to the result in ***Sutherland Lumber***, the company's deduction for the such personal use of the plane is limited to the amount that ultimately got included in the employee's gross income.

Code §163(j) - Limitation on Business Interest:

☞**Service Updates Guidance on Sec. 163(j) Interest Expense Limitation**

The IRS is providing **updated FAQs** to some basic questions about the limitation on the deduction for business interest expense, also known as the "section 163(j) limitation." Prior to the 2017 **Tax Cuts and Jobs Act (TCJA)**, **Code §163(j)** applied only to certain interest paid or accrued by corporations. However, the **TCJA** significantly changed the **Code §163(j)** limitation. On March 27, 2020, **Code §163(j)** was further amended by the **Coronavirus Aid, Relief, and Economic Security Act (CARES Act)**. The Treasury Department and the IRS issued final regulations under **Code §163(j)** in September 2020 and January 2021. (Cf. **T.D. 9905 and 9943**).

Sec. 163(j) Limitation: Generally, taxpayers can deduct interest expense paid or accrued in the taxable year. However, if the **Code §163(j)** limitation applies, the amount of deductible business interest expense in a taxable year cannot exceed the sum of:

- The taxpayer's business interest income for the taxable year;

- 30% of the taxpayer's adjusted taxable income (ATI) for the taxable year; and

- The taxpayer's floor plan financing interest expense for the taxable year.

Under the **CARES Act**, a different percentage (i.e., 50%) of ATI applied for taxable years beginning in 2019 and 2020.

For taxable years beginning *after* December 31, 2017, the limitation applies to *all* taxpayers who have business interest expense, other than certain "qualified small businesses" that meet the "gross receipts test" in **Code §448(c)** (for 2023, average gross receipts for three most recent tax years of $29 million or less). This gross receipts limitation, however, does *not* apply to certain "electing real estate trades or businesses" (and, certain "excepted trades or businesses").

Comment: The following are "excepted trades or businesses:" (1) The trade or business of providing services as an employee; (2) Certain real property trades or businesses that elect to be excepted; (3) Certain farming businesses that elect to be excepted; and (4) Certain regulated utility trades or businesses.

Real Property T/B Election: A taxpayer with an eligible real property trade or business or farming business may make an election to be an "excepted trade or business" by following the procedures outlined in **Reg. §1.163(j)-9**, including the requirement to attach a statement to a timely-filed federal income tax return (including any extensions) for the taxable year of election.

Comment: This election, however, comes with a "cost" of having to use ADS (i.e., 20 years, S/L method instead of a 15-year MACRS recovery period) on QIP, while also making it ineligible for bonus depreciation on such assets. In addition, MACRS depreciation is stretched out to 30 years for residential real estate, while commercial property must use 40 years. **(Code §163(j); Sec. 163(j) Limitation)**

☞**Sec. 481(a) Adjustment From Accounting Method Change Impacts Sec. 163(j) Business Interest Deduction Calculation (CCA 202123007)**

The IRS has held that a taxpayer's "net negative section 481(a) adjustment" resulting from a change in its method of accounting for depreciation must be added back in the calculation of the taxpayer's **Code Sec. 163(j)** business interest deduction limitation. It has also provided its opinion on this calculation where somewhat different facts apply.

Background - Section 481(a) adjustments: In computing taxable income for any tax year, if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding tax year was computed, then there is taken into account those adjustments (i.e., Sec. 481(a) adjustments) which are determined to be necessary solely by reason of the change, in order to prevent amounts from being duplicated or omitted. (**Code Sec. 481(a); Reg §1.481-1(a)**)

Generally speaking, the period over which a section 481(a) adjustment is made is:

- Four tax years (i.e., year of change and next three tax years) for a *positive* adjustment (i.e., an increase in taxable income); the change is taken into account ratably over the period, and

- One tax year (i.e., just the year of change) for a *negative* adjustment (i.e., a decrease in taxable income). (**Rev. Proc. 2002-19**)

Background - Limit on Deduction of Business Interest: **Code §163(j)** generally limits the amount of business interest expense that can be deducted in the current tax year for tax years beginning *after* December 31, 2017. The formula for computing the limitation includes determining the taxpayer's "adjusted taxable income" (ATI) for the tax year. (**Code §163(j)(1)**) **Reg. §1.163(j)-1(b)(1)** provides that

ATI is the tentative taxable income of the taxpayer for the tax year adjusted by certain items. Under **Reg. §1.163(j)-1(b)(43)**, tentative taxable income generally is determined in the same manner as taxable income under **Code §63** but for **Code §163(j)** purposes is computed without regard to the application of the **Code §163(j)** limitation. Under **Reg. §1.163(j)-1(b)(1)(i)**, for tax years beginning *before* January 1, 2022, depreciation is added back to tentative taxable income to determine ATI.

Facts: Taxpayer A, a calendar year taxpayer, changed its method of accounting for depreciation with respect to certain depreciable property, beginning with 2020 (i.e., the year of change). It determined that it had incorrectly classified certain 5-year property that it placed in service in 2017 as 7-year property. The change in the method of accounting for depreciation resulted in a $100x "net negative section 481(a) adjustment."

Impact of Negative Sec. 481(a) Adjustment: The "net negative section 481(a) adjustment" (i.e., $100x) is the difference between:

a. The total amount of depreciation for the depreciable property at issue taken by Taxpayer A from 2017 (i.e., the tax year the property was placed in service) to 2019 (i.e., the tax year before the year of change) using a 7-year recovery period and

b. The total amount of depreciation allowable for the property under the new method of accounting (i.e., using a 5-year recovery period) from 2017 to 2019.

Furthermore, $100x is the amount of depreciation computed under **Code §168** and included in the computation of "tentative taxable income for 2020" as a Sec. 481(a) adjustment. As a result, Taxpayer A adds $100x to its tentative taxable income to determine ATI for the 2020 tax year.

Impact of Positive Sec. 481(a) Adjustment: If a change in the method of accounting for depreciation result in a "net positive section 481(a)adjustment" due to the taxpayer's prior method of deducting depreciation that is *greater* than depreciation allowable, the addback to tentative taxable income in computing ATI under **Code §163(j)** is *a negative* amount equal to the "net positive section 481(a) adjustment." However, if the taxpayer takes this "net positive section 481(a) adjustment" into account in computing taxable income ratably over 4 tax years, beginning with the year of change, the taxpayer should add back only the *ratable portion* (i.e., 25%) of the net positive section 481(a) adjustment taken into account for the tax year.

It should be noted that the addback of the depreciation amount, including any section 481(a) adjustment for the year of change, for purposes of determining ATI is allowed only for tax years beginning *before* January 1, 2022. Therefore, if, for example, a calendar-year taxpayer's "net positive section 481(a) adjustment" due to a change in method of accounting for depreciation is $200x and the taxpayer takes $50x into account in computing taxable income each tax year beginning in 2020 through 2023, the taxpayer should include negative $50x in tax years beginning in 2020 and 2021 for purposes of determining ATI. The taxpayer may *not* include the remaining $50x in each tax year beginning in 2022 and 2023. **(Code §163(j); Sec. 481(a) Adjustment)**

☞**Final Sec. 163(j) Business Interest Deduction Limitation Regulations (TD 9943)**

The IRS has issued final regulations that provide additional guidance regarding the limitation on the deduction for business interest expense under **Code §163(j)**, as amended by the **Tax Cuts and Jobs Act** and the **CARES Act**. The regulations address, among other things, the calculation of "adjusted taxable income" (ATI) and the application of the limitation to Controlled Foreign Corporations (CFCs). The regulations also provide guidance regarding the definitions of real property development , real property redevelopment , and syndicates . The regulations affect taxpayers that have business interest expense, particularly pass-through entities, their partners and shareholders, as well as foreign corporations and their U.S. shareholders. The final regulations also clarify provisions in a previously-released final regulation. The final regulations apply to tax years beginning *on or after* the date that is 60 days *after* the regulations are published in the Federal Register. **(Code §163(j); Interest Expense)**

> **Note: The 30% of "adjusted taxable income" limit (i.e., down from 50%) will now be applied in 2021. It had been delayed from 2018 through the 2020 tax years (retroactively by the CARES Act).**

☞**IRS Provides Guidance on Certain Elections under Sec. 163(j) (Rev. Proc. 2020-22)**

The IRS has provided guidance on the **Code §163(j)(7)(B)** election to be an "electing real property trade or business" and the **Code §163(j)(7)(C)** election to be an "electing farming business" for purposes of the business interest expense limitation rules. Specifically, taxpayers can make a late election, or withdraw an election, on an amended federal income tax return, an amended **Form 1065**, or an "administrative adjustment request" under **Code §6227** (as outlined in **Rev. Proc. 2020-23**). In addition, the IRS has issued guidance on electing (1) out of the 50% Adjusted Taxable Income (ATI) limitation for tax years beginning in 2019 and 2020, (2) to use the taxpayer's ATI for 2019 to calculate the Section 163(j) limit for 2020, and (3) out of deducting 50% of excess business interest expense for tax years beginning in 2020 without limitation. **(Code §163; Interest Expense)**

> **Comment:** One reason why an electing real property or farming trade or business might wish to withdraw its election out of the business interest expense limitation involves bonus depreciation. The **Code §163(j)(7)** election comes with a trade-off, which is that an electing business must depreciate certain property more slowly using the alternative depreciation system (i.e., ADS over 20-year recovery period), while also *not* being eligible for bonus depreciation.

☞**Impact of "Real Estate Trade or Business Election" Under §163(j)**

The **TCJA** has now put a cap on the deduction of interest expense if the business has average gross receipts of > $25 million for the prior three tax years (and, indexed for inflation after 2018). In making this determination, the "attribution rules" of **Code §§267** and **707(b)** have to be considered. If this threshold is exceeded, then the current interest expense deduction is limited to the sum of: (1) interest income (if any) of the business; (2) 30% of "adjusted taxable income;" and (3) interest expense associated with "floor financing."

> **Comment:** The **instructions** to **Form 8990** state " If a pass-through entity is *not* required to file **Form 8990** because it is a "small business taxpayer," but a partner or shareholder is required to file **Form 8990**, the pass-through entity may be requested to provide certain information (i.e., interest expense) so that the partner or shareholder can complete their return.

A taxpayer (for example, one holding numerous real estate assets directly or indirectly though a flowthrough entity such as an LLC) otherwise subject to this new limitation on interest expense can instead choose to make a "real estate trade or business election." But, it comes with a "price tag." Namely, any *remaining basis* on either 27.5- residential or 39-year commercial real estate has to be switched over from GDS to ADS. For properties placed in service *before* 2018, this would mean *residential* properties would have to convert from the remainder of the normal 27.5-year MACRS recovery period to what would have otherwise remained had an ADS recovery period of 30 years instead been used from the point at which the asset was first put into service (i.e., 2.5 years would now have to be added to what would have been the remaining GDS recovery period). For *commercial* properties (regardless of when first placed in service), the conversion is what remains of the ADS recovery period of 40 years (i.e., so only *one* year would have to be added to what remained of the 39-year GDS recovery period).

Example: "Residential Buildings Placed in Service Before 2018"
A taxpayer places in service an apartment complex costing $1 million in Jan., 2017 which would initially have a MACRS recovery period of 27.5 years using the GDS S/L method. Then, in 2018 with the passage of the **TCJA**, a "real estate trade or business election" is made so as to avoid the cap on any interest expense deduction (e.g., mortgage interest). Instead of having approximately 26.5 years left to recover the cost of the building, any remaining undepreciated basis would have to be recovered over the next 27.5 years (i.e., ADS life of 30 years - one year's depreciation for 2017, after considering the mid-month convention).

Comment: Originally, such buildings would have had to be depreciated over what remained based on an ADS period of 40 years (i.e., instead of just 30 years).

Example: "Residential Buildings Placed in Service After 2017"
Same as the Example above, except the building was placed in service in 2018 (i.e., instead of 2017). Under the ADS method, the recovery period for a residential building would be 30 years instead of the normal GDS MACRS recovery period of 27.5 years, using the mid-month convention.

Impact of Election on MACRS Real Estate with < 20 Years Classlife: Any MACRS real estate (*not* tangible personal property) with a classlife of 10, 15 or 20 years which would otherwise qualify for bonus depreciation would now be denied this immediate write-off if a "real estate trade or business election" is otherwise made in order to avoid the interest expense limitation imposed by **Code §163(j)**. Nevertheless, unlike MACRS real estate in either the 27.5- or 39-year class, these real estate assets (e.g., single- or multi-purpose ag or horticultural structures, land improvements, car wash buildings, gas station/convenience stores or billboards) would *not* be forced to use ADS (v. GDS) depreciation methods. **Only "qualified improvement property" would be forced to use an ADS recovery period of 20 years (i.e., instead of the normal MACRS life of just 15 years).** They would, however, lose the right to claim any bonus depreciation on these "shorter-life" real estate assets (but, as stated above, tangible personal property assets in the MACRS 3- 5- or 7-year would be unaffected by this election and you could still elect bonus depreciation if so desired).

Example: "Land Improvements on Building with "Real Estate T/B Election"
A residential or commercial building is placed in service in 2018 (or, later) and has some "land improvements" (e.g., parking lot, sidewalks, landscaping) done alongside of it. The taxpayer decides to make a "real estate trade or business election" under **Code §163(j)** in order to avoid the cap on any deduction of mortgage interest. As a result, the real estate would have to be depreciated using the ADS (v. GDS) method meaning that a longer 30- or 40-year recovery period would have to be employed to recover its cost. But, the land improvements would still be depreciable under the GDS MACRS recovery period of 15 years, though bonus depreciation could *not* be claimed.

The taxpayer in this example also acquired and placed in service some MACRS 5- and 7-year property (e.g., appliances or office F&F). This "real estate T/B election" would *not* affect the ability of the taxpayer to claim bonus depreciation on this tangible personal property. Nor, would ADS v. GDS have to be used to recover any remaining cost (i.e., to the extent bonus depreciation or Sec. 179 immediate expensing was *not* claimed).

☞**FAQs on Sec. 163(j) Interest Expense Limitation**
The IRS has issued **updated answers** to some basic questions about the limitation on the deduction for business interest expense, also known as the "Section 163(j) limitation." Prior to the **2017 Tax Cuts and Jobs Act (TCJA)**, **Code §163(j)** applied only to certain interest paid or accrued by corporations.

However, the **TCJA** significantly changed the **Code §163(j)** limitation. On March 27, 2020, **Code §163(j)** was further amended by the **Coronavirus Aid, Relief, and Economic Security (CARES) Act**. These questions and answers address the **Code §163(j)** limitation after amendments by the **TCJA** and the **CARES Act**. **(Code §163(j); Interest Expense)**

> **Comment:** Keep in mind that the "price tag" for making this election is that "qualified improvement property" (QIP) is not eligible for bonus depreciation. Furthermore, such improvements must be depreciated using the "alternative depreciation system" (ADS) over a 20-year recovery period as opposed to the normal 15-year MACRS recovery period using the S/L method.

☞**Qualified Residential Living Facility Safe Harbor for Sec. 163(j) Business Interest Deduction (Rev. Proc. 2021-9)**

The IRS is providing a "safe harbor" for "qualified residential living facilities" to elect to be an "electing real property trade or business" for purposes of the rules that limit the business interest deduction. This revenue procedure emphasizes some key points to keep in mind as follows:

- **Reg. §1.163(j)-9** provides rules and procedures for making an election under **Code §163(j)(7)(B)** to be an "electing real property trade or business"

- **Code §469(c)(7)(C)** defines "real property trade or business" as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business

- **Code §168(g)(1)(F)** provides that an "electing real property trade or business" within the meaning of **Code §163(j)(7)(B)** must use the alternative depreciation system (ADS) for property described in **Code §168(g)(8)** (i.e., residential rental and commercial real property, along with QIP)

The IRS is once again clarifying that residential living facilities that include the provision of supplemental assistive, nursing, or routine medical services are eligible to make the election as "real property trades or businesses" under **Code §163(j)(7)(B)**. (**Notice 2020-59**)

Definition of Qualified Residential Living Facility: A "qualified residential living facility" is either:

1.A residential living facility that:

a. Consists of multiple rental dwelling units within one or more buildings or structures that generally serve as primary residences on a permanent or semi- permanent basis to individual customers or patients;

b. Provides supplemental assistive, nursing, or other routine medical services; and

c. Has an average period of customer or patient use of individual rental dwelling units of 90 days or more; or

2. A residential living facility that qualifies as "residential rental property" under **Code §168(e)(2)(A)**

Code §168 - Depreciation - Partial Dispositions:

☞**IRS Releases Revised Audit Technique Guide on Cost Segregation (IRS Pub. 5653)**

Audit Technique Guides (ATGs) are intended to assist IRS examiners during audits "by providing insights into issues and accounting methods unique to specific industries." While ATGs are designed to provide guidance for IRS employees, they are also useful to small business owners and tax professionals who prepare returns. The IRS has recently released an updated comprehensive ATG to assist in evaluating cost segregation studies submitted by taxpayers in support of depreciation deductions when property is acquired or constructed. When only lump-sum costs are available, "cost estimating techniques" may be needed in order to segregate costs to individual components of property. **(Misc.; Cost Seg Studies)**

> **Comment:** The update was necessitated due to changes in the tax law which affected **Code §263A**, changes in accounting method, depreciation, bonus depreciation, Section 179 deduction, Section 179D deduction, and Qualified Improvement Property (QIP).

☞IRS "Process Unit" Examining Partial Dispositions of Buildings

The IRS has issued a **Process Unit** that provides guidance to its auditors for examining a taxpayer that elected to recognize a disposition as a "partial disposition" of a building under **Reg. §1.168(i)-8(b)(2)**.

Background: The **Modified Accelerated Cost Recovery System (MACRS)** is used to recover (i.e., depreciate) the basis of most business and investment property (i.e., depreciable assets) placed in service after 1986. (**IRS Pub. 946, "How to Depreciate Property"**) A "depreciable asset" is property owned by a taxpayer that has a determinable useful life of *more than one year* that is *used in the taxpayer's business or income-producing activity*. In order to depreciate an asset, the taxpayer generally must have a "depreciable interest and basis in the asset." Usually a taxpayer has a "depreciable interest" in depreciable assets the taxpayer owns. However, leased property may be depreciated if the taxpayer "retains the incidents of ownership," such the risk of loss if the property is destroyed, in the property. Generally, a taxpayer's "unadjusted basis" in an asset is the asset's cost to the taxpayer. The taxpayer's adjusted basis is the asset's unadjusted basis adjusted for improvements and depreciation.

A building, including its structural components, used in a taxpayer's trade or business or in an income-producing activity, is a depreciable asset (**Reg. §1.168(i)-8(c)(4)(ii)(A)**), and each improvement or addition PIS *after* the original building is placed in service is a "separate depreciable asset." (**Reg. §1.168(i)-8(c)(4)(ii)(D)**) Generally, the "structural components" of a building are walls, partitions, floors, and ceilings, any permanent coverings such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. (**Reg. §48-1(e)(2)**)

A *portion* of a building is any part of the building that is less than the *entire* building. (**Reg. §1.168(i)-8(b)(4)**) **Reg. §1.168(i)-8(d)(2)** allows taxpayers to elect to recognize partial dispositions of MACRS property (i.e., "partial disposition election"), including the disposition of a portion of a building or one or more of its structural components. (**Reg. §1.168(i)-8(d)(2)**) The "partial disposition election" is an annual election and is made by reporting the gain or loss on a timely-filed original tax return, including extensions, for the tax year in which the taxpayer disposes of a portion of the building. (**Reg. §1.168(i)-8(d)(2)(ii)**)

> **Comment:** The "partial disposition election" came about as a result of the "repair regs" which were released in the fall of 2013. Nevertheless, it still seems to fly in the face of the repeal by Congress (as part of **ERTA '81**) of the "component depreciation" approach taken by taxpayers with regard to the depreciation of real estate assets. Furthermore, there has been no "sale or exchange" of the building itself. So, how is it possible to claim a Sec. 1231 ordinary loss without this

prerequisite? Even the regs state that "Generally, a "disposition" occurs when ownership of an asset is transferred or when the asset is permanently withdrawn from use in the taxpayer's trade or business or income producing activity." (**Reg. §1.168(i)-8(b)(2)**)

IRS Examination Guidelines: The IRS has set out what auditors should look for when examining taxpayers who have made a "partial disposition election" with regard to a disposal of part of a building. According to the **Process Unit**, once an examiner has determined there is a risk that the taxpayer did *not* comply with the rule for reporting a partial disposition of a building (or, its structural components), the examiner will need to follow the "five steps" below to examine the compliance issue:

- First, the examiner should determine if the taxpayer partially disposed of a building or one of its structural components such as a sprinkler system. To do this, the examiner needs to review the taxpayer's records and confirm that the taxpayer has maintained records for its depreciable assets using the rules in **Reg. §1.167(a)-7(c)**. Also, the examiner should interview the taxpayer to evaluate how the taxpayer determined that a "partial disposition" occurred during the tax year. If the taxpayer cannot substantiate that a disposition occurred, the **Process Unit** recommends that the examiner disallow the partial disposition.

- Second, the examiner should identify exactly what portion of the building (or, structural components) the taxpayer disposed of. The examiner should review the taxpayer's books and records to determine whether they provide enough information to substantiate the identity of the portion of the building (or, structural component(s)) the taxpayer disposed of. The examiner should also verify that the taxpayer has a depreciable interest in that property.

- Third, the examiner should identify the building that was partially disposed of and its placed in service date. Again, the examiner will need to review the taxpayer's books and records. According to the **Process Unit**, a taxpayer should use the "specific identification method" of accounting when the taxpayer disposes of an entire building (or, a portion of a building). (**Reg. §1.168(i)-7(b); Reg. §1.167(i)-8(h)(3)(i)**) The "specific identification method" requires the taxpayer to put the building, or portion of the building being disposed of, in a "single asset account," (i.e., an account that holds only one asset). When it is impracticable to identify the partially disposed of building using the taxpayer's books and records because the taxpayer did *not* use the specific identification method, the taxpayer may use one of the "simplified identification methods" (such as First-In-First-Out (FIFO or modified FIFO) provided in the disposition regs to identify the portions of a building disposed of. (**Reg. §1.168(i)-8(g)(2) and Reg. §1.168(i)-8(g)(3)**)

- Fourth, the examiner should determine the adjusted basis of the disposed of portion of the building in order to verify that the taxpayer properly calculated gain or loss on the disposition of that portion. According to the **Process Unit**, the examiner's starting point for determining the adjusted basis of the disposed of portion of a building is the "unadjusted basis" of the *entire* building. Once the unadjusted basis of the entire building is determined, then the adjusted basis of the disposed of portion can be computed. The examiner should remember to account for any additional first-year depreciation that is attributable to the disposed portion of the building.

- Fifth, the examiner needs to verify that the taxpayer reduced the adjusted basis of the remaining portion of the building to account for the partial disposition. The examiner should check that the remaining asset reflects only its remaining adjusted basis. **(Code §168; Partial Dispositions)**

Code §179 - Immediate Expensing Election:

☞**Sec. 179 Immediate Expensing Increasing to $1,160,000 (Notice 2022-55)**

The annual cap on Sec. 179 immediate expensing is going up to $1,160,000 from $1,080,000 in 2022. Meanwhile, the phaseout limit commences at $2,890,000 (up from $2,700,000 in 2022). Bonus depreciation, however, is slated to go down from 100% to just 80% in 2023 unless Congress acts in the interim to extend the 100% allowance. For "heavy vehicles" such as SUVs, the Sec. 179 cap will be set at $28,900 for 2023 (although bonus depreciation could be used instead to circumvent this cap). Bonus depreciation can also be used to increase the first-year "luxury car cap" by $8,000.

Some key items to keep in mind on these two deductions:

- A number of states only allow Sec. 179 and not bonus depreciation (and, even a limited $25,000 cap on Sec. 179 in selected states). So, Sec. 179 immediate expensing should be consider in these selective states instead of solely claiming bonus depreciation on the federal tax return.

- Sec. 179 must be elected on **Form 4562** whereas bonus depreciation continues to be automatic unless an "election out" by MACRS class is included in the tax return (and, normally, an amended return cannot be used to make this "election out" of bonus depreciation).

- Sec. 179 can be elected (or, revoked) on an amended return (assuming that the tax year is still open). On the other hand, assuming that an "election out" of bonus depreciation was *not* in effect for the year that otherwise qualifying property was first placed in service, this deduction can only be "caught up" by filing a **Form 3115** for a "change in the method of accounting" for the taxpayer.

> **Comment:** This "catching up" on missed depreciation is an "automatic consent" situation and therefore no user fee need to be paid when filing **Form 3115**. And, the "DCN Code #7" which indicates that the taxpayer is changing from an "erroneous method of accounting to a correct one" should be listed on page one of the form.

- Both write-offs can be used on either new or used property (due to the change made by the **TCJA**)

- There is no cap on the bonus depreciation amount, nor can it be "phased out." Furthermore, bonus depreciation can create (or, increase) an NOL (although it might be subject to the new **Code §461(l)** "excess business loss" limitation). Conversely, the Sec. 179 immediate expensing amount must be "covered" with sufficient "trade or business taxable income." Other limitations such as insufficient at-risk basis (for a flowthrough entity owner) or the passive loss rules might come into play to prevent these write-offs (nevertheless the basis of the asset(s) involved is fully reduced in the interim).

- Sec. 179 and bonus (and regular) depreciation are only available for business property that you "placed in service" during the tax year. Property is "placed in service" when it is ready and available for its assigned function in your business. As long as it is available for such use, you do *not* have to actually use the property for business during the year to take depreciation.

Code §197 - Amortization of Goodwill and Certain Other Intangibles:

☞**Start-up Expenses Amortizable Over 180 Months** (***Kellett***, **TC Memo. 2022-62 (6/14/2022)**)

A taxpayer's internet business was considered to have begun when he actually opened his website and made it available to the public. The key factor was that this was when his business began providing the services for which it was organized, with an eye to long-term profit, according to the Tax Court. One of the unusual facts in this case was that this was true despite the fact that the taxpayer made no attempt to earn revenue during that first year of operation. Nevertheless, these expenses for the start-up of his business that he incurred *before* the exact date his website opened had to be capitalized and amortized over 180 months. (**Code §197; Start-up Costs**)

> **Comment**: The first $5,000 of start-up expenses can be written off currently, as long as the total for such expenses does not exceed $50,000.

☞**Start-up Expenses Not Currently Deductible** (***Harrison*, TC Summ. Op. 2022-6 (5/12/2022)**)

The Tax Court confirmed that expenses incurred *before* actually beginning a business are *not* currently deductible. This was a case of a corporate consultant who was a full-time employee but who was also "in the early stages of opening her own company." As part of the process, she networked and participated in speaking engagements to build up clientele and her brand. She also worked with a firm to set up her website, but only reported $400 in gross receipts. Agreeing with the IRS, the Tax Court concluded that this was *not* sufficient to establish that her business was up and operating. The bottom line was that her initial research and solicitation of potential customers did *not* rise to the level of actually carrying on a trade or business. (**Code §197; Start-up Costs**)

Code §274 - Meals & Entertainment Expenses:

☞**Final Regs Issued on Meals and Entertainment Deduction (IR-2020-225)**

The IRS has issued final regulations (**TD 9925**) on the business expense deduction for meals and entertainment following changes made by the **Tax Cuts and Jobs Act (TCJA)**. The final regulations adopt rules proposed in February 2020 with modifications in response to certain comments. Specifically, the final regulations address the disallowance of the deduction for expenditures related to entertainment, amusement, or recreation activities, including the applicability of certain exceptions to this disallowance. They also provide guidance in determining whether an activity is considered "entertainment." Despite comments to the contrary, the final regulations provide that the term "entertainment" does *not* include food or beverages unless they are provided at or during an entertainment activity and the costs of the food or beverages are *not* separately stated from the entertainment costs. (**Code §274; M&E Expenses**)

> **Comment:** While there is no deduction for "entertainment expenses," the write-off for "meals" is now back down to just 50% for 2023.

Code §280F - Luxury Car Caps:

☞**2023 Luxury Car Caps & Annual Income Inclusion Amounts (Rev. Proc. 2023-14)**

Rev. Proc. 2023-14 provides: (1) two tables of limitations on depreciation deductions for owners of passenger automobiles placed in service by the taxpayer during calendar year 2023; and (2) a table of dollar amounts that must be used to determine income inclusions by lessees of passenger automobiles with a lease term beginning in calendar year 2023 where the FMV of the leased vehicle is $60,000 or more. The tables detailing these depreciation limitations and amounts used to determine lessee income inclusions reflect the automobile price inflation adjustments required by **Code §280F(d)(7)**.

Luxury Car Caps: The **Code §280F** depreciation deduction limits for passenger autos (including trucks and vans) first placed in service during 2023 are listed in these tables. For passenger autos acquired after 9/27/17, placed in service during 2023, and subject to bonus depreciation under **Code §168(k)**, the depreciation limits are $20,200 for the first year, $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year (i.e., $58,360 for the first four years). For passenger autos placed in service during 2023 that are *not* subject to **Code §168(k)** bonus depreciation (i.e., an "election out" of bonus depreciation was made for MACRS 5-year property), the depreciation limits are $12,200 for the first year (i.e., the extra $8,000 for bonus depreciation is eliminated), $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year (i.e., $50,360 for the first four years). **(Code §280F; Luxury Car Caps)**

> **Comment:** Not electing out of bonus depreciation continues to add $8,000 to the first-year luxury car cap amount (even though bonus depreciation will be dropping down to only 80% for 2023).

☞ **IRS Issues 2022 Luxury Car Caps for Passenger Vehicles (Rev. Proc. 2022-17)**

The IRS has issued updated tables containing: (1) Depreciation deduction limits for passenger automobiles (including trucks and vans) placed in service in 2022; and (2) Dollar amounts that must be used to determine the "annual income inclusion amounts" for such vehicles first leased in 2022. With regard to bonus depreciation deduction, taxpayers with qualified property (including passenger automobiles) may claim an additional first-year depreciation deduction equal to 100% for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. But, bonus depreciation is *not* allowed if, in 2022, the taxpayer:

1. Failed to use the passenger automobile more than 50% for business purposes;

2. Elected out of taking an additional first-year depreciation deduction;

3. Acquired the passenger automobile used and the acquisition failed to meet certain requirements; or

4. Acquired the passenger automobile *before* September 28, 2017, and placed it in service *after* 2019.

For passenger vehicles acquired *after* 9/27/17, placed in service during 2022, and subject to bonus depreciation under **Code §168(k)**, the depreciation limits are $19,200 for the first year, $18,000 for the second year, $10,800 for the third year, and $6,460 for each succeeding year (i.e., $54,460 for the first four years). For passenger autos placed in service during 2022 that are *not* subject to Section 168(k) bonus depreciation, the depreciation limits are $11,200 for the first year, $18,000 for the second year, $10,800 for the third year, and $6,460 for each succeeding year (i.e., $46,460 for the first four years).

With regard to the "income inclusion amount," **Code §280F(c)(2)** reduces the amount allowable as a depreciation deduction to a taxpayer who leases a passenger automobile. This reduction is supposed to be "substantially equivalent to the depreciation deduction limits imposed on taxpayers who actually own passenger vehicles." To accomplish this reduction, taxpayer lessees must include in gross income an amount (i.e., "income inclusion amount") determined by applying a formula to a dollar amount obtained from a table pursuant to **Reg. §1.280F-7(a)**.

Rev. Proc. 2022-17 contains three updated tables as follows:

Table 1: Provides depreciation deduction limits for passenger automobiles acquired by the taxpayer *after* September 27, 2017, and placed in service by the taxpayer during calendar year 2022, to which the additional first-year depreciation deduction applies.

Table 2: Provides depreciation deduction limits for passenger automobiles placed in service by the taxpayer during calendar year 2022, for which the taxpayer is *not* entitled to an additional first-year depreciation deduction (i.e., based on the restrictions listed above).

Table 3: Provides a taxpayer who leases a passenger automobile (with a lease term beginning in 2022) with the dollar amount to be used to determine the "income inclusion amount" for that automobile. The table provides dollar amounts for a range of fair market values. **(Code §280F; Luxury Car Caps)**

Comment: This revenue procedure applies to automobiles placed in service during calendar year 2022 or with a lease term beginning in calendar year 2022.

☞**Interaction of Sec. 179 and Bonus Depreciation on Luxury Car Caps**

Rev. Proc. 2019-13 provides a "safe harbor method" of accounting for determining depreciation deductions for passenger automobiles that qualify for bonus depreciation and that are also subject to the "luxury car caps" found in **Code §280F(a)**.

Comment: This discussion also covers the impact on the calculation of each year's depreciation deduction where Sec. 179 immediate expensing is elected in the *same* (i.e., first) year that bonus depreciation applies (i.e., an "election out" of bonus is *not* being made for the 5-year MACRS class for the year that the vehicle is placed into service).

Comment: This revenue procedure applies to any passenger vehicle that has a cost (i.e., unadjusted basis) which exceeds the current first-year luxury car cap (i.e., $20,200 for 2023) and for which Sec. 179 was *not* elected, but bonus depreciation otherwise applied (i.e., there was no "election out" of bonus depreciation for the tax year that the vehicle was placed in service).

For a passenger automobile that is qualified property under **Code §168(k)** and for which the additional first year depreciation deduction is otherwise allowable, **Code §168(k)(2)(F)(I)** increases the first year luxury car cap under **Code §280F(a)(1)(A)(i)** by $8,000.

Code §280F(d)(1) provides that any deduction allowable under **Code §179** for a passenger automobile is subject to the limitations of **Code §280F(a)** in the *same* manner as if it were a depreciation deduction allowable under **Code §168**.

Potential Issue with Bonus Depreciation: If the original basis of the vehicle was greater than the applicable luxury car cap for the year placed in service (i.e., $20,200 for 2023), and 100% bonus depreciation was claimed, the excess could *not* be deducted until the 5-year MACRS recovery period had ended while also being subject to the cap which otherwise applied for the 4th year and later (i.e., $6,960 for vehicles placed in service in 2023). As a result, for a vehicle costing more than $20,200 in 2023, you would get no depreciation deduction for years 2024 through 2028 with this excess being claimed starting in 2029, subject to the $6,960 cap.

Comment: The 5-year MACRS recovery period with the half-year convention would run from the middle of the first year until the middle of the sixth year. So, if the rule outlined above applied, depreciation of any excess basis would *not* recommence until the seventh year.

Example: "Depreciating Luxury Vehicle w/o Safe Harbor"
A taxpayer purchases a vehicle in 2023 costing $60,200 for which 100% bonus depreciation applies, but for which no Sec. 179 immediate expensing amount is elected. Without the "safe harbor" discussed below, they would deduct $20,200 for the year placed in service (i.e., 2023), but nothing for years 2024 through 2028. Then, starting in 2029, $6,960 could be claimed for the remaining $40,000 of undepreciated basis remaining until the entire cost of the vehicle had been deducted (i.e., $40,000 divided by $6,960/year would mean that the car would *not* be fully depreciated until 5.75 years later, or 2034 for a vehicle first placed in service in 2023). In other words, it would take 12 tax years (i.e., 2023 to 2034) to fully depreciate this "luxury vehicle."

Safe Harbor Addresses Issue: To mitigate the anomalous result that occurs in the taxable years subsequent to the placed-in-service year and before the first taxable year succeeding the end of the recovery period for a passenger automobile, the IRS has offered a "safe harbor alternative." This safe harbor method of accounting is elected by simply applying it to deduct depreciation of its passenger automobile for the first taxable year *succeeding* the placed-in-service year of the passenger automobile as follows:

1. The 200% DB MACRS depreciation schedule for 5-year property (i.e., as listed in **Rev. Proc. 87-56**) must be used;

2. For the placed-in-service year of the passenger automobile, the taxpayer deducts the *first* year limitation amount under **Code §280F(a)(1)(A)(i)** (i.e., $20,200 for 2023); and

3. For the taxable year subsequent to the placed-in-service year and for each succeeding taxable year in the recovery period, the taxpayer determines the depreciation deduction for the passenger automobile by multiplying the remaining adjusted depreciable basis of the passenger automobile by the annual depreciation rate for each taxable year subsequent to the placed-in-service year (i.e., again, using the 200% DB MACRS depreciation schedule for 5-year property), subject to the annual **Code §280F** luxury car cap amounts.

> **Comment:** As discussed in **Rev. Proc. 2023-14**, for vehicles placed in service in 2023, $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year.

4. Any excess still remaining after the end of the sixth year (i.e., again, with the half-year convention, the 5-year MACRS recovery period runs from the middle of the first year until the middle of the sixth year) is treated as a deductible depreciation expense for the succeeding taxable years, subject to the limitation under **Code §280F(a)(1)(B)(ii)** (i.e., $6,960 for each succeeding tax year for vehicles placed in service in 2023) until the total remaining cost of the vehicle if fully depreciated.

Example: "Depreciating Luxury Vehicle w/ Safe Harbor"
A taxpayer purchases a vehicle in 2023 costing $60,200 for which 100% bonus depreciation applies, but for which no Sec. 179 immediate expensing amount is elected. With the "safe harbor," they would claim bonus depreciation equal to $20,200 (i.e., first year luxury car cap) for 2023. Then, the remaining basis of $40,000 would be claimed in the ensuing years (i.e., using the 200% DB MACRS depreciation table for 5-year property) limited to the car caps listed above (i.e., $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year). As a result, 32% x $40,000 = $12,800 for 2024; 19.2% x $27,200 = $5,222 for 2025; 11.52% x $21,978 = $2,532 for 2026; 11.52% x $19,446 = $2,240 for 2027; 5.76% x $17,206 = $991 for 2028. The total depreciation claimed for tax years 2023 through 2028 equals $20,200 + $23,785 = $43,985. Therefore, heading into the 2029 tax year, there is still $60,200 - $43,985 = $16,215 of basis remaining to be depreciated. Using the $6,960 car cap for the fourth and succeeding tax years, you would take $6,960 for 2029; $6,960 for 2030; and the final $2,295 for 2031.

Example: "Depreciating Luxury Vehicle w/ Sec. 179 Immediate Expensing, But Electing Out of Bonus Depreciation"
A taxpayer purchases a vehicle in 2023 costing $60,200 for which a Sec. 179 immediate expensing election is made on **Form 4562** for $12,200. He made this decision since his business is located in a state that allows Sec. 179 immediate expensing, but nothing for bonus depreciation. Also, note that the luxury car cap for the first year is only $12,200 (v. $20,200) since an election out of bonus depreciation has been made for all MACRS 5-year property for 2023 (i.e., the year that the vehicle was placed in service).

For the remainder of the 5-year MACRS recovery period (i.e., 2024 to 2028), he would use the 200% DB table in **Rev. Proc. 87-56**. As a result, he would get $12,200 for the year that the vehicle was placed in service which would leave $50,000 to be depreciated going forward as follows: 32% x $50,000 = $16,000 for 2024; 19.2% x $34,000 = $6,528 for 2025; 11.52% x $27,472 = $3,165 for 2026; 11.52% x $24,307 = $2,800 for 2027; 5.76% x $21,507 = $1,239 for 2028. The total depreciation claimed for tax years 2023 through 2028 equals $12,200 + $30,468 = $42,668. Therefore, heading into the 2029 tax year, there is still $60,200 - $41,932 = $18,268 of basis remaining to be depreciated. Using the $6,960 car cap for the fourth and succeeding tax years, you would take $6,960 for 2029; $6,960 for 2030; and the final $4,348 for 2031.

<u>Example</u>: "Depreciating Luxury Vehicle w/ Sec. 179 Immediate Expensing, But Failing to Elect Out of Bonus Depreciation"
A taxpayer purchases a vehicle in 2023 costing $60,200 for which a Sec. 179 immediate expensing election is made on **Form 4562** for $20,200. He made this decision since his business is located in a state that allows Sec. 179 immediate expensing, but nothing for bonus depreciation. Since *both* Sec. 179 and bonus depreciation apply for 2023, the luxury car cap would still limit the overall depreciation deduction to just $20,200. But given that an election out of bonus depreciation was *not* made in 2023 for MACRS 5-year property, **no depreciation can be claimed for tax years 2024 through 2028.** Then, starting in 2029, subject to the $6,960 luxury car cap that applies for the fourth and succeeding tax years, the remaining $40,000 would be would be recovered over the next 5.75 years (i.e., 2029 through 2034).

<u>Comment</u>: The obvious alternative is to lease a "luxury car" and therefore be able to simply deduct the annual lease payments, less the rather minor "annual income inclusion amount," for each tax year (i.e., given that the FMV for the vehicle was $60,000 or more when first placed in service). Another option would be to purchase a "heavy SUV" which would have a Sec. 179 cap of $28,900 for 2023, but no cap if bonus depreciation would instead claimed. **(<u>Code §280F</u>; Luxury Car Caps)**

<u>Comment</u>: Unless Congress acts, bonus depreciation would begin to phase out at a rate of 20% per year starting in 2023. So, in the examples above, unless a "tax extenders" bill was passed, bonus depreciation would only be 80%.

<u>Code §446 - General Rules for Method of Accounting</u>:

☞**Retirement Community's Accounting Method Validated by Tax Court (*Continuing Life Communities Thousand Oaks LLC*, T.C. Memo 2022-31 (4/6/2022))**

The Tax Court issued a memorandum opinion finding that a company which owned and operated a continuing care retirement community had correctly accounted for a portion of the up-front payments from its residents when calculating taxable income. The taxpayer collected three types of fees from its residents: a contribution amount, a deferred fee, and monthly fees. The taxpayer followed Generally Accepted Accounting Principles (GAAP) in accounting for the deferred fees. The IRS argued that using GAAP to account for fees was *not* allowed under the tax code. The IRS has the discretion to determine the method of accounting unless it constitutes an abuse of discretion but "the history of how that discretion came to be weakens its power to overcome text, purpose, and analogy." The Tax Court granted the taxpayer's motion for summary judgment on its accounting for deferred fees. **(<u>Code §446</u>; Accounting Methods)**

<u>Comment</u>: For all years at issue, Continuing Life had substantial losses as its deductions were vastly greater than its gross income: It took losses of about $9.2 million in 2008, $3.15 million in 2009, and $850,000 in 2010.12 During those years, Continuing Life recognized Deferred Fee income of only $34,188 in 2008, $420,187 in 2009, and $421,727 in 2010. In response, the IRS sent the notice of final partnership administrative adjustment (FPAA) for the 2008–10 tax years that proposed increasing Continuing Life's tax bill by nearly $20 million.

Comment: After reading this entire opinion of the Tax Court, the key was that even though the amount of the "Deferred Fee" that the continuing care facility was fixed in amount after the resident had been there for four years or more, it was *not* earned and remained contingent upon the facility fulfilling its obligation to provide care for the remainder of the resident's life, or until they voluntarily decided to move out. Furthermore, although it could receive interest-free loans of these "deferred fee" amounts on deposit, the funds were held in a separate trust over which the continuing care facility had no dominion or control. And, the facility had to completely repay any outstanding loan amount associated with a particular ex-resident's account *before* the trustee of these funds would released the fee otherwise earned by the company.

Code §461 - General Rule for Taxable Year of Deduction:

☞New Safe Harbor for Common Improvements for Real Estate Developers (Rev. Proc. 2023-09)

Rev. Proc. 2023-09 *obsoletes* **Rev. Proc. 92-29** and provides new rules and conditions for implementing the optional safe harbor method of accounting for real estate developers to determine when "common improvement costs" may be included in the basis of individual units of real property in a real estate development project to determine the gain or loss from the sale of those units. Under the **Alternative Cost Method**, a developer includes the share of the estimated cost of common improvements allocable to the units sold in the basis of such units regardless of whether the costs have been incurred under **Code §461(h)** (i.e., "all-events test"), subject to certain limitations. This revenue procedure also provides guidance on the application of the **Alternative Cost Method** to long-term contracts accounted for under **Code §460** and the regulations thereunder.

Developers that want to use the **Alternative Cost Method** generally will be required to apply the method to *all* qualifying projects in a trade or business instead of on a "per-project basis" as was required under **Rev. Proc. 92-29**. Developers will also be permitted to use a "short" **Form 3115, Application for Change in Accounting Method**, to make method changes to apply the **Alternative Cost Method** if: (1) each change results in a **Code §481(a)** adjustment of zero, and (2) waives the eligibility rule in **section 5.01(1)(f)** of **Rev. Proc. 2015-13** which prohibits taxpayers from filing an "automatic method change" if the taxpayer has made or requested a change for the *same* item during the 5 taxable years ending with the year of change **(Code §461; Common Improvements)**

Comment: The term "common improvement" means any real property or improvements to real property that benefit two or more units that are separately held for sale that the developer reasonably anticipates it will incur under **Code §461(h)** during the ten succeeding taxable years (i.e., a "super accrual" ten-taxable year horizon). The developer must be contractually obligated or required by law to provide the common improvement and must *not* be able to recover the cost of the common improvement through depreciation (i.e., since these improvements become part of the basis of the "inventory lots" being sold). Examples of common improvements include streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools.

Comment: A key requirement is that this "safe harbor" for common improvements anticipated to be made by the real estate developer must be done by the due date (including extensions) for the first tax year in which these "inventory units" will be sold.

Code §1234A - Forfeited Deposits:

☞**Forfeited Deposits from Canceled Sale of Sec. 1231 Property Resulted in Ordinary Income (*CRI-Leslie, LLC*, 121 AFTR 2d 2018-794 (11th Cir., 2/15/2018))**

The taxpayer entered into an agreement with an unrelated third party to sell a hotel. The agreement fell through, however, and the taxpayer received $9.7 million in forfeited deposits. The deposits were reported as Section 1234A capital gain on Schedule K of the taxpayer's return. The IRS recharacterized the gain as ordinary income, concluding that **Code §1234A** applies only to "capital assets" and *not* "Section 1231 property." The Tax Court agreed, holding that a strict reading of **Code §1234A** indicates that it does *not* include Section 1231 property because such property is explicitly excluded from the definition of a "capital asset" pursuant to **Code §1221**. On appeal, the 11th Circuit *affirmed* the Tax Court's decision, finding that "the clear language of **IRC Sec. 1234A** trumps any implied intent behind the statute." **(Code §1234A; Forfeited Deposit)**

Code §6015 - Innocent Spouse:

☞**New, Uninformed Wife Granted Innocent Spouse Relief (*Di Giorgio*, TC Memo. 2023-44 (3/29/2023))**

Due to the facts in this case, the taxpayer's new wife was *not* held liable for a fraudulent tax deficiency on a joint return due to "innocent spouse relief." When the couple first met in 2006, she was only 26 years old, lived in the Philippines with two young sons and was *not* college-educated. They married shortly thereafter. On their first 2007 **Form 1040**, zero taxable income was listed. Also, a great deal of income from the husband's business and his other investments was omitted. As a result, the Tax Court agreed that he underreported income and therefore subjected him to the fraud penalty. Nevertheless, the Court also decided that the wife should *not* be liable for any of the deficiency or penalties due to a number of factors. Her husband verbally abused her while also controlling the family finances and paying the household bills. In fact, the 2007 **Form 1040** was the first time the wife ever saw a U.S. tax return. They then separated in 2019. And since the separation, the wife was making little money while being the sole support of her sons. Most importantly, the wife lacked any knowledge of the unreported income. **(Code §6015; Innocent Spouse)**

☞**Ex-Wife Still Living with Former Husband Granted Innocent Spouse Relief (*Pocock*, TC Memo. 2022-55 (6/6/2022))**

A divorced woman who still lived with her ex-husband was nevertheless eligible for innocent spouse relief. As a result, she was *not* liable for tax debts stemming from the joint returns which had claimed fraudulent refunds and filed when they were married. She did *not* review the returns or sign them. Meanwhile, her husband physically and verbally abused her. Even though she financially benefitted from the ill-gotten refunds, she did *not* participate in any of his fraudulent schemes. For example, he lied to her about how he got his money. In addition, she would suffer economic hardship if she had to pay the joint income tax liabilities. **(Code §6015; Innocent Spouse)**

☞**Innocent Spouse Relief Not Available for Unpaid Payroll Taxes (*Chavis*, 158 TC No. 8 (6/15/2022))**

The 100% penalty applies when employers fail to remit withheld payroll taxes. In this instance, a woman and her then-husband were officers of a corporation that did *not* pay over withheld employment taxes to the IRS. After the IRS could *not* collect the taxes from the business, it assessed the 100% trust fund recovery penalty against the couple. The ex-wife insisted that she should be treated as an "innocent spouse" and therefore should *not* be liable for the amount. But the Tax Court agreed innocent spouse relief applies only to unpaid tax liabilities associated with a joint federal income tax return. **(Code §6015; Innocent Spouse)**

☞**Spouse Who Knew Taxes Weren't Paid Still Got Equitable Innocent Spouse Relief (*Grady*, TC Summ. 2021-29 (8/17/2021))**

The Tax Court has held that, *both* for a tax year with respect to which a wife did *not* know her joint return taxes were not being paid by her husband, and for several years with respect to which she did know her joint return taxes were not being paid, the wife was entitled to equitable innocent spouse relief.

Tax Court Decision: In concluding that the taxpayer qualified for "streamlined relief" in 2006, the Court concluded that she was no longer married to her ex-husband when the IRS issued its final determination. In addition, she would "suffer economic hardship" if relief was *not* granted. A requesting spouse will "suffer economic hardship" if payment of part or all of the tax liability "will cause the requesting spouse to be unable to pay reasonable basic living expenses." The determination as to what constitutes a "reasonable amount for basic living expenses" may vary with the circumstances of the individual taxpayer but will *not* include the "maintenance of an affluent or luxurious lifestyle." (**Rev. Proc. 2013-34, §4.03(2)(b)**)

The taxpayer testified that she was employed and had earned $14,190.52 in 2018 at the time of the trial. The Court has taken judicial notice that the poverty level for one person in 2018 was $12,140. She did *not* own a car or a house. Instead, she lived with her elderly and sick parents and then her new husband who owned the house she lived in and the cars she used. Also, she did *not* have reason to know that her ex-husband would *not* pay the 2006 joint Federal income tax liability. When the couple filed their 2006 joint Federal tax return, he requested an installment agreement within 30 days after the return was filed that would apply to the 2006 tax liability. Therefore, when the taxpayer signed the 2006 joint Federal income tax return, she did *not* know or have reason to know that the underpayment would not be paid. As a result, she qualified under "multiple equitable factor relief" for the other years. As to the other tax years in question, the Court held that each of the factors weighed in favor of relief other than the "knew-or-had-reason-to-know factor." For example, the Court looked to the same factors noted above in determining that the wife met the "economic hardship test." And the Court noted that the "significant benefits" test weighed in her favor (i.e., she did *not* receive a "significant benefit" from the failure to pay the outstanding tax liabilities). **(Code §6015; Innocent Spouse)**

☞**IRS Releases Draft Form and Instructions for Requesting Innocent Spouse Relief**

The IRS has released a new draft of **Form 8857, Request for Innocent Spouse Relief**, and accompanying draft instructions. Among other changes, the 2021 draft **Form 8857** and draft instructions reflect the **Taxpayer First Act's** limitation on the Tax Court's review of IRS innocent spouse determinations.

Innocent Spouse Relief: This relief is for liability protection with regard to a joint tax debt. When married individuals file a joint return, they normally become joint and severally liable for any tax due on that MFJ return. "Joint and several liability" means that the IRS is able to collect the *entire* amount of any tax due from *either* spouse who signed the joint return.

> **Comment:** Keep in mind that **Form 8379, Injured Spouse Allocation** can be filed (at least while the couple is still married and filing joint returns) to protect the refund of the one spouse by holding them *not* liable when the other spouse is responsible for certain taxes not being paid and the "injured spouse" has no reason to know of this shortfall.

Meanwhile, **Code §6015** provides different types of relief from this joint and several liability (i.e., innocent spouse relief) whereby one of the spouses uses **Form 8857** to request innocent spouse relief. Married taxpayers who did *not* file joint returns, but who otherwise lived in community property states, may request relief from liability for tax attributable to an item of community income.

Taxpayer First Act: The **TFA** added **Code §6015(e)(7)**, which changed the scope of the Tax Court's review of requests for innocent spouse relief. Under **Code §6015(e)(7)**, the Tax Court's review of an IRS determination denying a request for innocent spouse relief is limited to:

a. The administrative record "established at the time of the determination," and

b. Any additional newly discovered or previously unavailable evidence.

Changes to Form 8857 and Instructions: Both the 2021 draft of **Form 8857** and the 2021 draft instructions alert requesting spouses that "they need to make the administrative record as complete as possible" because **Code §6015(e)(7)** limits the Tax Court's review of IRS denials of innocent spouse relief requests. Both the draft form and instructions also reference **IRS Pub. 971, Innocent Spouse Relief** contains descriptions of the factors that the IRS considers when evaluating claims for innocent spouse relief, as well as other helpful information for requesting spouses. Also, the 2021 draft **Form 8857**:

- Allows requesting spouses to change their address of record by checking a box;

- Provides the requesting spouse with the ability to authorize the IRS to leave a voice message at the phone number they provided;

- Allows the requesting spouse to indicate their primary or preferred language for communicating with the IRS;

- Allows the requesting spouse to provide their "best or safest" phone number;

- Replaces various checkboxes with spaces for narrative descriptions and explanations about the requesting spouse's situation; and

- Modifies the question "did you sign a joint return" to read "did you intend to file a joint return." **(Code §6015; Innocent Spouse)**

☞**Innocent Spouse Relief Granted for Return Filed Before Embezzlement Arrest But Not Conviction (*Jacobsen*, TC Memo 2018-115 (7/25/2018))**

In June 2011, the taxpayer's wife, an accountant, was arrested for embezzling approximately $485,000 from her employer over several years. She was convicted of her crimes in November 2011 and sentenced in January 2012. Although the couple's 2010 and 2011 joint returns were timely filed, they failed to report the embezzled funds as income. Upon audit, the IRS added back the embezzlement income and also imposed an accuracy-related penalty. In 2014, the taxpayer filed for innocent spouse relief, claiming that he was "completely unaware of his wife's embezzlement scheme until her arrest." But, the IRS denied this request. The Tax Court then sided with both parties, finding that the taxpayer was entitled to relief for 2010 because that return was filed *before* his wife's arrest. However, he was *not* entitled to relief for 2011 because he had actual knowledge of the embezzlement income when that return was actually filed. **(Code §6011; Innocent Spouse)**

Code §6038D - Foreign Asset Reporting:

Taxpayer Subject to Willful FBAR Penalty in Excess of Regulatory Cap (*Kimble*, 122 AFTR 2d 2018-XXXX (Ct. Fed. Cl., 12/27/18))

For the years at issue, the taxpayer owned investment accounts in Switzerland and France. However, she failed to report any investment income from the accounts on her returns, nor did she file **Reports of**

Foreign Bank and Financial Accounts (FBARs). After learning about the IRS's efforts to uncover secret foreign accounts, the taxpayer applied to the **Offshore Voluntary Disclosure Program (OVDP)**. However, she decided to withdraw from the program and "take her chances" after seeing the proposed penalty. The IRS responded by imposing a willful failure to file penalty of $697,229 which represented an amount greater than the regulatory maximum of $100,000. The Court of Federal Claims upheld the penalty, concluding that the taxpayer's "reckless conduct amounted to a willful failure to file." Also, the Court found that 2004 revisions to the statute effectively nullified the regulatory cap. **(Code §6038D; Foreign Asset Reporting)**

☞**Supreme Court Holds FBAR Penalties Apply on "Per Report Basis" (*Bittner v. U.S.*, No. 21-1195 (S. Ct., 2/28/2023))**

The U.S. Supreme Court held that the penalty for violating the **Report of Foreign Bank and Financial Accounts (FBAR)** rules to report a qualifying account applies "on a per-report basis," and *not* "on a per-account basis." In ***Bittner***, the U.S. taxpayer failed to file FBARs while living in Romania. Upon learning of his reporting obligations, he filed FBARs that incorrectly stated his interest in 25 or more qualifying accounts (i.e., taxpayer actually had 272 foreign accounts). The U.S. government assessed $2.72 million in civil penalties for "non-willful violations" for *each* unreported account, the $10,000 maximum penalty for his 272 unreported accounts. A district court reduced the assessment to $50,000 for failure to file five annual FBARs. The court's decision resolved a split between the 5th Circuit, which held the penalty applied on a "per-account basis," and the 9th Circuit, which held the penalty applied on a "per-report basis." **(Code §8938; FBAR)**

> **Comment:** Taxpayers who have a financial interest in (or, signature authority over as indicated in the question on **Schedule B**) foreign financial accounts must file a **Report of Foreign Bank and Financial Accounts (FBAR)** on **Financial Crimes Enforcement Network (FinCEN) Form 114** if the aggregate value of the foreign financial accounts exceeds $10,000 at *any* time during the calendar year. In a recent case, a federal district court entered a $3.1 million consent judgment for "willful FBAR penalties" owed by a taxpayer. Not only does **Form 114** need to be filed with the FinCEN, **Form 8938 (Statement of Specified Foreign Financial Accounts)** also needs to be *separately* filed with the IRS when individual clients, estates, and trusts have foreign bank accounts and foreign financial accounts. (***U.S. v. Manafort, Jr.*, 131 AFTR 2d 2023-XXXX (DC FL, 2/22/2023)**).

> **Comment:** It should be noted that this was a very divided 5-to-4 opinion by the Supreme Court.

☞**Supreme Court Upholds Million Dollar FBAR Penalty (*U.S. v. Bussell*, 120 AFTR 2d 2017-6379,(9th Cir., 10/25/2017) *cert denied* 4/30/2018)**

The Supreme Court has declined to review a 9th Circuit decision, *affirming* a district court, which found that a taxpayer willfully failed to file a **Report of Foreign Bank and Foreign Accounts (FBAR)** with regard to her foreign account. The 9th Circuit rejected a variety of the taxpayer's arguments, including that the imposition of the penalty violated the U.S. Constitution's "excessive fines clause" and that it was barred by the relevant treaty provisions. **(Code §6038D; Foreign Asset Reporting)**

> **Comment:** After weighing the factors relevant to the an excessive fines inquiry, the district court concluded that IRS's assessment raised some Eighth Amendment concerns because the assessment exceeded the maximum penalty set out in the applicable criminal and civil statutes. The maximum authorized penalty for a "willful criminal FBAR violation" was a five year sentence and a $250,000 fine. (**31 U.S.C § 5322(a)**) The taxpayer's FBAR penalty was $1,221,806, which was almost five times the maximum amount allowed in the criminal statute. However, in response, the district court only decreased the penalty imposed from $1,221,806 to $1,120,513, which represented the maximum amount permitted under the applicable civil statute.

Comment: The fine for "willful failures" can be as large as 50% of the account value, and if there are multiple years (as there were in this case), it can end up actually exceeding the amount in the unreported account.

Code §6050P - Third-Party Information Returns:

☞**IRS Provides Guidance on Ethics of Tax Practitioner Sending Form 1099-C to Delinquent Client**

While withholding final judgment because it felt it did *not* have sufficient information to make such a judgment, IRS's **Office of Professional Responsibility (OPR)** has noted several potential areas in which a tax practitioner who sends **Form 1099-C, Cancellation of Debt**, to delinquent or nonpaying clients, could run afoul of provisions governing practice before IRS.

Background: Under **Code §61(a)(12)**, a discharge of indebtedness is generally in the gross income of the debtor. Nevertheless, pursuant to **Code §108**, certain discharges of indebtedness are excluded from gross income (under a variety of exceptions listed on **Form 982, Part 1**).

Form 1099-C Information Reporting: In general, **Code §6050P** requires an "applicable entity" to issue an information return if it discharges $600 or more of indebtedness. Applicable entities include governmental entities and financial entities including "any organization a significant trade or business of which is the lending of money." (**Code §6050P(c)(2)(D)**) Under **Reg. §1.6050P-1(b)(1)**, indebtedness is deemed "discharged" for purposes of the **Code §6050P** reporting obligation only upon the occurrence of an "identifiable event." The term "identifiable event" includes an applicable entity's discharge of indebtedness in accordance with a "decision" or "defined policy" (i.e., a written policy or established business practice) of the entity to "discontinue collection activity," such as after the end of a period of nonpayment. (**Reg. §1.6050P-1(a)(1) and Reg. §1.6050P-1(b)(2)(i)(G)**)

Treasury Circular 230: Rules governing the recognition of professionals representing clients before the IRS are spelled out in Treasury Department Circular No. 230 which spells out the requirements practitioners must meet, as well as their duties, while providing sanctions for practitioners who do *not* comply. **(Code §6050P; Form 1099-C)**

Code §6321 - Lien for Taxes:

☞**Owner Liable for Corporate Tax Debt as Alter Ego of Entity (*Lothringer*, 126 AFTR 2d 2020-5663 (DC TX 8/11/2020))**

A federal district court has determined that a corporation's owner was the entity's "alter ego" and, therefore, should be held personally liable for the corporation's tax debt. Generally, a corporation, and *not* its shareholders, is liable for its own debts. But, under state (here, Texas) law, a court may ignore the corporate form "when the corporation is the alter ego of its owners or shareholders." The alter ego principle applies "when there is such unity between corporation and individual that the separateness of the corporation has ceased and holding only the corporation liable would result in injustice."

Determining the existence of such unity is shown from the total dealings of the corporation and the individual, including the degree to which corporate and individual property have been kept separately, the amount of financial interest, ownership and control the individual maintains over the corporation, and whether the corporation has been used for personal purposes. (***Western Horizontal Drilling, Inc. v Jonnet Energy Corp.*, 11 F3d 65 (5th Cir., 1994)**)

A court will analyze various factors to determine if a corporation's owner is its alter ego and look at the totality of the circumstances. (***Century Hotels*, 69 AFTR 2d 92-543 (5th Cir., 1992)**)

Under **Code §6321**, the amount of a person's tax liability is a lien in favor of the government on *all* property belonging to that person.

The government is permitted to levy on assets held in an alter ego's name in satisfaction of a corporation's liability. (***G.M. Leasing Corp.*, 39 AFTR 2d 77-475 (S Ct 1977)**)

District Court Decision: The Court determined that the taxpayer was the "alter ego" of corporation. Some of the key factors that the IRS asserted included:

- The taxpayer was the only shareholder, officer, director, and owner of the corporation;

- The taxpayer exercised complete dominion and control over the corporation;

- The taxpayer organized the corporation;

- The taxpayer failed to observe certain corporate formalities, including failing to file federal income tax returns and Texas Franchise Tax Public Information Reports for various years; and

- The taxpayer assumed a $52,000 debt of the corporation owed to an individual.

The IRS also produced evidence of multiple checks written from the corporation's account to the taxpayer's wife, despite the fact that she was *not* an employee of the corporation. And, the taxpayer did *not* dispute that these funds were used for personal or household expenses but argued that they qualified as either "constructive dividends" or "a non-taxable return of capital."

The bottom line was that the court determined that "there was such unity between the corporation and the taxpayer that the separateness of the corporation ceased and that holding only the corporation liable for the taxes would result in injustice." **(Code §6321; Limited Liability)**

☞**Successfully Removing IRS Tax Liens**

Taxpayers must formally request the IRS to withdraw a tax lien once their tax liability is completely extinguished. The Service will withdraw the lien, provided that the taxpayer has paid their tax debt, the IRS has released the lien, and the taxpayer has been tax-compliant for the past three years. A withdrawal of a tax lien expunges the lien immediately from the debtor's records, and it is as if the lien had never been filed. **Form 12277** should be used to request a withdrawal of the lien. In addition, a taxpayer is entitled to ask for a lien withdrawal even if they have *not* fully repaid the debt, provided the amount that they currently owe the Service does *not* exceed $25,000 and an agreement is reached with the IRS to pay off the remaining balance via monthly debits from the taxpayer's bank account. **(Code §6321; Tax Liens)**

Code §6330 - Notice and Opportunity for Hearing Before Levy:

☞**Tax Court Demands IRS at Least Consider Offer-in-Compromise (*Whittaker*, TC Memo 2023-59 (5/15/2023))**

The Tax Court found that the IRS was being "too inflexible" when it rejected a retired couple's OIC of $1,629 on an outstanding tax liability of $33,000. They claimed that in retirement and having significant other debts outstanding, while suffering from the effects of the COVID pandemic, this was all that they could offer. But the IRS insisted that they had the means through equity in their home and other income sources to pay the entire debt. In response, the Tax Court stepped in and found that the Service had "abused their discretion" in rejecting the couple's offer outright with no suggested compromise to settle the tax debt due. As a result, the Court sent the case back to Service's Office of Appeals for a possible settlement. **(Code §6330; Offers-in-Compromise)**

> **Comment:** The wife was a family and community-empowerment specialist for a local school district who also worked part time as a tutor and as a mall security guard. Meanwhile, the husband was a veteran and self-employed personal trainer. The couple faced financial hardship long before the tax year in question. They also had significant unpaid debts, including even unpaid student loans of more than $60,000, and other personal debt of about $10,000. As far as their tax troubles, they owed the IRS income tax for tax years 2004-06 and 2018. And they owe Minnesota about $9,700 for their 2015 tax year.

☞**Case Illustrates IRS Authority to Re-Allocate Payments for Back Taxes (*Melasky*, No. 19-60084 (5th Cir., 2/3/2020))**

Generally, taxpayers can direct the IRS as to how they want to allocate a "voluntary partial payment" of back taxes. On the other hand, the IRS has a great deal of discretion in applying *involuntary* payments, such as levies. In this instance, a couple who owed multiple years of income taxes hand-delivered a check to the IRS and specifically designated it for payment of their 2009 taxes. Nevertheless, *before* the IRS deposited the check, it decided to levy the couple's bank account and applied the proceeds to taxes owed for 1995, 1996 and 1999-2004. That levy caused the check for the 2009 taxes to bounce. The couple claimed they made a "voluntary payment" when they gave the check to the IRS, but the court affirmed that "a check is conditional until the bank accepts it." In other words, "involuntary payments may generally be applied against whichever unpaid tax liabilities the Commissioner chooses". **(Code §6311; IRS Levies)**

> **Comment: Reg. §301.6311-1(b)(1)** differentiates between "tendering" a check and its being "paid." "Checks do *not* represent final payment . . . but rather constitute only conditional payment which becomes absolute when the creditor presents the check to the bank which then honors it." (***Weber v. Commr.*, 70 T.C. 52, 57 (1978)**)

> **Comment:** Under the CARES Act, the IRS has suspended *new* tax levies from April 1 through July 15. But it will *not* automatically release or pause levies that were already in place. Taxpayers who can show that an existing levy "is causing an economic hardship" such that they are unable to pay "reasonable living expenses" can request the IRS to release it. Clients should contact the IRS revenue officer that they have been working with. Otherwise, they should call the number on the notice of levy, or fax their request to 855-796-4524.

Code §6402 - Authority to Make Credits or Refunds

☞**Final Regulations on Misdirected Direct Deposit Refunds Issued (TD 9940)**

Enacted on 7/1/19, the **Taxpayer First Act of 2019 (TFA)** required the IRS to establish procedures to allow for (1) taxpayers to report instances in which a refund was *not* electronically transferred to their account; (2) coordination with financial institutions to identify and recover the transferred amounts; and (3) the delivery of the refund to the correct account (**Code §6402(n)**). The IRS has now released final regulations under **Code §6402(n)** that satisfies the Service's obligation under the **TFA**. These final rules "largely adopt the regs proposed in December 2019 (**REG-116163-19**), with minor modifications." In general, the regulations follow current IRS procedures for the reporting, identification, recovery, and delivery of misdirected direct deposit refunds. **(Code §6402; Tax Deposits)**

> **Comment:** The final rules apply to any report of a "misdirected direct deposit refund" for a current

or prior year submitted after the publication of the final regulations in the Federal Register.

Code §6511 - Limitations on Credit or Refund:

☞**Longer 7-Year SOL for Claiming Refund Not Applicable** (***Taha*, Case: 20-2061 (Fed. Cir., 3/7/2022)**)

In this instance, the taxpayer finally filed his claim for a tax refund after the normal three-year statute of limitations had expired. This was in violation of the general rule that refund claims must be filed within three years of the return's filing date or two years of the time the tax is paid, whichever is later. This three-year period, however, is extended to seven years when a refund claim is filed in order to deduct a business bad debt. The taxpayer maintained that the seven-year period should have been applied, but an appeals court denied the claim, upholding the Service's position that his refund claim did *not* relate to any business debt.

Code §166 - Business Bad Debt Deduction: Code §6511(d)(1) extends the time for filing a refund claim from three years to seven years from the date the tax return was due: (1) where the refund relates to "bad debt" that became worthless and therefore subject to deduction under **Code §166** or **Code §832(c)** (i.e., the "bad business debt" exception); or (2) where the refund relates to a "loss from worthlessness of a security" that is subject to deduction under **Code §165(g)**. **(Code §6511; Bad Debt Deduction)**

> **Comment:** Keep in mind that where an owner lends their business monies out of their own funds, any non-repayment would constitute a "non-business bad debt" (i.e., which would be treated as a short-term capital loss). And, as opposed to a capital contribution by the owner (which would become part of their overall stock basis and, therefore, must be *completely* worthless in order to claim a write-off), partial deduction of a non-business bad debt is allowed. Finally, starting in 2021, remember that there is no longer the ability to carryback an NOL (i.e., so there is no need to include a statement in the return to forgo the NOL carryback). NOLs can now only be carried forward indefinitely (and, are distinguishable from a business bad debt).

☞**Financial Disability When Filing Late Tax Refund Claims**

Financial disability can serve as a legitimate reason for allowing a late-filed refund claim. The normal three-year statute-of-limitations period for seeking a tax refund is extended in cases in which taxpayers are found to have been unable to manage their financial affairs because of medically diagnosed, serious long-term physical or mental impairments. Nevertheless, proving eligibility for this late filing relief can be difficult as demonstrated in the following cases.

First of all, this relief applies only to individuals and *not* to refund claims of estates. For example, a woman who was appointed as executrix of her aunt's estate timely filed an estate tax return and paid the tax. Five years later, she then filed an amended Form 706, seeking a refund stating that it was late of her mental ailments. Although the court was sympathetic, it refused to extend financial disability to estate tax returns (***Carter*, D.C., Ala.**).

In addition, this relief will also not apply if someone else is authorized to act for the taxpayer with regard to their financial matters. For instance, an elderly man gave his son a written power of attorney over his affairs, allowing the son to act on his dad's behalf in financial transactions. But, again, this precluded the tolling of the normal three-year refund claim period (***Stauffer*, 1st Cir.**). **(Code §6511; Tax Refunds)**

Code §6651 - Penalty for Failure to File or Pay Tax:

☞**Taxpayer Qualified for Reasonable Cause Exception Regarding IRS Penalties (*Tracy*, TC Summ. Op. 2023-30 (6/3/2023))**

Petitioner was a **Schedule C** sole proprietor who operated a law practice. The taxpayer's assistant failed to timely file returns or pay his employment tax liabilities for the periods ending 9/30/17 through 6/30/19. During this time, the petitioner was 87 years old and was closing his law practice because of his declining health. The petitioner was *not* aware that his assistant had not performed her duties. Upon learning of the unfiled returns and unpaid taxes, he promptly filed and paid the taxes and requested abatement of the penalties. The Tax Court was to decide whether the petitioner's failure to timely file returns and timely pay employment taxes was due to reasonable cause and *not* "willful neglect." The Court found that the petitioner was *not* liable for additions to tax under **Code §6651(a)(1)** and **(2)** "due to his inability to adequately supervise his assistant." **(Misc.; Code §6651)**

> **Comment:** It is somewhat disconcerting that this matter could *not* be settled at the IRS audit or appeals level, forcing the taxpayer the time and expense to pay these penalties and then file his case with the Tax Court seeking a refund.

☞**IRS Updates First-time Abatement for Penalty Relief**

The IRS has updated its "first-time abate" (FTA) policy after a report from the Treasury Inspector General for Tax Administration (TIGTA) found the policy had *not* been consistently administered and that few taxpayers qualifying for relief actually requested it. Based on a taxpayer's compliance history, FTA relief is potentially available for the (a) failure-to-file penalties under **Code §§6651(a)(1), 6698**, and **6699**; (b) failure to pay penalties under **Code §§6651(a)(2)** and **6651(a)(3)**; and (c) failure to deposit penalties under **Code §6656**. But, the updated policy does require that in order to be granted relief, a taxpayer must have filed all currently required returns (or, valid extensions) and paid or arranged to pay any tax due. However, relief under this policy is *not* available for information reporting penalties, including delinquent foreign information returns. **(Misc.; Tax Penalties)**

> **Comment:** Use of the FTA can be requested by calling the **IRS Practitioner Priority Service** (PPS) line at (866) 860-4259.

> **Comment:** Under the "first-time abatement program," if a taxpayer has paid (or, arranged to pay) the tax due and has been tax-compliant for the past three years, the agency will approve a one-time waiver of the late-payment and late-filing penalties. In this instance, though, the IRS granted a penalty abatement to a woman who did *not* pay her taxes on time. However, the IRS only found out several years later that she did *not* qualify for relief because of this prior tax delinquency.

Code §6662 - Accuracy Related Penalty:

☞**Preparer's Mistakes Excuses Couple from Accuracy Related Penalty (*Trammer*, TC Bench Order (4/18/2023))**

The preparer of this couple's tax return made numerous mistakes when he claimed the same expenses multiple times on various forms and schedules of their **Form 1040**. The couple supplied the preparer with the necessary receipts and documents in order to compile their return but he nevertheless committed various errors and duplicative claiming of certain deductions. The Tax Court agreed with the IRS that these expenses should be disallowed, but sided with the couple that they should *not* be subjected to the accuracy related penalty for large understatements since they had "reasonably relied on their preparer and otherwise acted in good faith." **(Code §6662; IRS Penalties)**

Comment: To prepare their returns, the couple took their receipts to a return preparer who decided how and where to report items on the their return. Some of the personal expenses, such as home mortgage interest were reported in multiple places and double or triple counted. Many personal expenses, such as home maintenance and improvement, were instead reported as business expenses. Indirect business expenses (i.e., which should have been capitalized) were reported as direct business expenses. But the couple "clearly established that the errors were those of their return preparer on whom they relied." As a result, the Tax Court held that they were liable for the tax determined by the IRS but *not* for the penalties.

Comment: This case is a bit unusual insomuch as the Tax Court oftentimes holds the client responsible for the egregious actions of their tax preparer (even though the tax professional can be sued for malpractice).

☞**Disallowed Charitable Contribution Valued at Zero for Accuracy-related Penalty Purposes (*Fakiris*, TC Memo 2020-157 (11/19/2020))**

The Tax Court has found that a disallowed charitable donation should be valued at "zero" for purposes of determining the amount of the accuracy-related penalty. As a result, the taxpayer in this instance was subject to the 40% penalty for a "gross valuation misstatement."

Background: **Code §6662(a)** and **Code §6662(b)(3)** imposes an accuracy-related penalty equal to 20% of the portion of an underpayment of tax "attributable to * * * [a]ny substantial valuation misstatement." For purposes of **Code §6662**, "a substantial valuation misstatement" exists if "the value of any property (or, the adjusted basis of any property) claimed on any return of tax... is *150% or more* of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)". (**Code §6662(e)(1)(A)**) However, if the value or adjusted basis of the property claimed on the return is *200% or more* of the amount determined to be the correct amount of such value or adjusted basis, a "gross valuation misstatement" exists, and the penalty imposed increases to 40%. (**Code §6662(h)**)

A "gross valuation misstatement" is considered to exist when the correct value or adjusted basis of property is zero and the value or adjusted basis claimed on the return for such property is greater than zero. (**Reg. §1.6662-5(g)**) In ***Blau*, 23 AFTR 2d 2019-1960 (CA Dist Col, 5/24/2019)**, the district court completely disallowed a charitable contribution deduction for donations of a remainder interest, for failure to satisfy statutory substantiation requirements (i.e., the donor failed to file completed appraisal summaries). The court, nevertheless, found it necessary to ascertain the fair market value of the remainder interest in order to decide whether the value claimed on the return resulted in "gross" or "substantial" valuation misstatements for purposes of **Code §6662(h)**.

In another case, the transaction at issue concerned a taxpayer who contributed offsetting currency options to a partnership to create an artificially inflated basis in his partnership interest, which, following the subsequent liquidation of his partnership, ultimately resulted in his claiming significant non-economic tax losses. The Supreme Court found that the contribution of the currency options lacked economic substance and, therefore, the basis of the property contributed to the partnership was zero for purposes of determining whether there was a "gross" or "substantial" valuation misstatement. (***Woods*, 112 AFTR 2d 2013-6974 (S Ct, 10/9/2013)**) (**Code §6662; Tax Penalties**)

☞**Tax Attorney Still Liable for Substantial Underpayment Penalty Despite Relying on Tax Expert (*Babu*, TC Memo. 2020-121 (8/17/2020))**

A tax attorney's maintained that he should *not* be subject to a substantial underpayment penalty of almost $1.5 million, claiming the penalty "was erroneous because he relied in good faith on the advice of a qualified tax professional." But, the Tax Court rejected his pleas for a number of reasons, one of them being "the lawyer's ample tax experience." (**Code §6662; IRS Penalties**)

☞**Adequate Disclosure Rules Updated for Reducing or Avoiding Certain Penalties (Rev. Proc. 2019-42)**

The IRS has updated its "adequate disclosure" procedure. The procedure identifies when the disclosure of an item or position is adequate for purposes of reducing the accuracy-related penalty under **Code §6662(d)** and to avoid the tax return preparer penalty under **Code §6694(a)**.

Background - Accuracy-related Penalty: If **Code §6662** applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20% of the portion of the underpayment is added to the tax. The penalty increases to 40% in the case of "gross valuation misstatements" under **Code §6662(h)**, "non-disclosed non-economic substance transactions" under **Code §6662(i)**, or "undisclosed foreign financial asset understatements" under **Code §6662(l)**.

Except as provided in the next paragraph, there is a "substantial understatement of income" tax if the amount of the understatement exceeds the *greater* of:

i. 10% of the amount of tax required to be shown on the return for the tax year, or

ii. $5,000. (**Code §6662(d)(1)(A)**)

For corporations (other than S corporations or a personal holding companies), a "substantial understatement of income" tax exists when the amount of the understatement exceeds the *lesser* of:

i. 10% of the tax required to be shown on the return for a tax year (or, if greater, $10,000), or

ii. 10,000,000. (**Code §6662(d)(1)(B)**)

An "understatement" is the excess of the amount of tax required to be shown on the return for the tax year over the amount of the tax that is shown on the return reduced by any rebate. (**Code §6662(d)(2)(A)**) Generally, the amount of the understatement is reduced when a taxpayer has a "reasonable basis" for the tax treatment of the item causing the understatement (except when the item is attributable to a "tax shelter") and the relevant facts about the item's tax treatment are "adequately disclosed" on the return or in a statement attached to the return. (**Code §6662(d)(2)(B)(ii)**)

Background - Return Preparer Penalty: **Code §6694(a)** imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of tax liability due to an "unreasonable position" if the tax return preparer knew (or, reasonably should have known) of the position.

A position (other than a position with respect to a "tax shelter" or a "reportable transaction" to which **Code §6662A** applies) is "unreasonable" unless:

i. There is or was "substantial authority" for the position, or

ii. The position was "properly disclosed" under **Code §6662(d)(2)(B)(ii)(I)** and had a "reasonable basis."

A position taken with respect to a "tax shelter" or a "reportable transaction" is considered to be "unreasonable" unless it is reasonable for the return preparer to believe that the position would "more likely than not" be sustained on the merits. In **Rev. Proc. 2019-9**, the IRS set out the "adequate disclosure rules" applicable to tax year 2018.

Updated IRS Guidance: **Rev. Proc. 2019-42** also provides guidance on how to adequately disclose an item or position on a return for purposes of reducing accuracy-related and avoiding preparer penalties. Generally, a taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the amounts entered on these forms must be verifiable to comply with the Revenue Procedure. With this latest revenue procedure, the IRS has updated the tax years and tax forms to which the procedure applies, but has *not* made any substantive changes to the previously release guidance in **Rev. Proc. 2019-9**. **(Misc.; Tax Penalties)**

> **Comment: Rev. Proc. 2019-42** applies to any income tax return filed on a 2019 tax form for a tax year beginning in 2019, as well as income tax return filed on a tax form in 2020 for a short tax year beginning in 2020.

Code §7122 - Offers-in-Compromise:

IRS Issues Updated Offer-in-Compromise Forms (Form 656 Booklet, Offer-in-Compromise)
The IRS has issued an updated version of **Form 656-B, the "Form 656 Booklet, Offer in Compromise."** It includes updated versions of the various forms required when a taxpayer wishes to have IRS accept his offer-in-compromise (OIC).

> **Comment:** As indicated below, make sure that the taxpayer has filed all required returns. Otherwise, the IRS will return the application and the $186 filing fee, while applying any initial payment(s) that have already been made to the outstanding balance of tax otherwise due.

Background: An OIC is an agreement between the taxpayer and the IRS "that settles a tax debt for less than the full amount owed." To be considered, generally the taxpayer must make an appropriate offer based on what the IRS considers "the taxpayer's true ability to pay."

> **Comment:** There are two payment options. One is for "lump-sum cash" which requires 20% of the total "offer amount" to be paid up front, with the remaining balance to be paid in five (or, fewer) installments within five months of the date that the offer-in-compromise is officially accepted by the IRS. The other option is for a "periodic payment" whereby the first payment is made with the accepted OIC offer, and the remaining payments being made monthly over a 6-to-24-month period as negotiated with the IRS.

Instructions Contained in Form 656-B Booklet: The booklet sets out the rules, in laymen's terms, for making an offer-in-compromise and having it accepted. For example:

- **Eligibility:** Submitting an application does *not* ensure that the IRS will accept the OIC. To be eligible, the following conditions must be met:

1. File all tax returns legally required to file;

2. Have received a bill for at least one tax debt included on the offer;

3. Make all required estimated tax payments for the current year, and

4. Make all required federal tax deposits for the current quarter, if a business owner with employees.

- **Trust fund taxes:** If the business owes trust fund taxes, responsible individuals may be held liable for the trust fund portion of the tax. Trust fund taxes are the money withheld from an employee's wages, such as income tax, Social Security, and Medicare taxes. A business is *not* eligible for consideration of an OIC unless the trust fund portion of the tax is paid or the trust fund penalty determination(s) has/have been made on all potentially responsible individual(s). However, if submitting the OIC "as a victim of payroll service provider fraud or failure," the trust fund assessment is *not* required prior to submitting the offer.

- If individual and business tax debt is owed: If there is individual and business tax debt that a taxpayer wishes to compromise, the taxpayer needs to send in *two* separate **Forms 656**. In other words, taxpayers should complete one **Form 656** for their individual tax debts and one **Form 656** for their business tax debts. Each **Form 656** will require the $186 application fee and initial payment.

A "business" is defined as a corporation, partnership, or any business that is operated as other than a sole-proprietorship. An individual's share of a partnership debt will *not* be compromised. The partnership must submit its own offer based on the partnership's and partners' ability to pay.

- Forms contained in the booklet: The booklet contains the following updated forms and instructions for submitting an OIC.

- Form 433-A (OIC), Collection Information Statement for Wage Earners and Self-employed Individuals

- Form 433-B (OIC), Collection Information Statement for Businesses

- Form 656, Offer-in-Compromise

In addition, the IRS has announced that using *previous* versions of the forms may result in delayed processing of OIC applications.

> **Pre-Qualifier Tool:** The booklet instructs taxpayers to use the IRS's **OIC Pre-Qualifier Tool** to confirm that they are eligible for an OIC and to calculate a preliminary offer amount. **(Code §7122; Offer-in-Compromise)**

Code §7426 - Civil Actions by Persons Other than Taxpayers:

☞**IRS Improperly Levied Property Belonging to Decedent's Children (*Goodrich*, 125 AFTR 2d 2020-558 (DC LA 3/17/2020))**

A federal district court agreed that the IRS improperly levied property belonging to a decedent's children. The decedent held a life estate in certain property that was willed to the children by their mother as a remainder interest. As a result, the decedent's interest in that property ended when she died. Therefore, the children were entitled to get that property back since the IRS had no right to place a lien on that property. **(Code §7426; IRS Liens)**

Code §7451 - Petitions:

☞**Tax Court Denies Petition Filed 11 Seconds Late (*Sanders, Antawn*, 160 T.C. No. 16 (6/20/2023))**

The taxpayer e-filed a deficiency petition via the Tax Court's electronic filing system (DAWSON) 11 seconds after the filing deadline expired and his petition was dismissed as untimely. The taxpayer logged onto DAWSON and started the e-filing process earlier in the evening of the filing deadline date using his phone but had to switch to his computer to upload the file, which delayed the receipt of his petition to after the deadline. Although **Code §7451** could extend the filing period when a clerk's office or filing location was inaccessible, that was *not* the case here. Traditionally, the courts have defined "inaccessibility" to refer to physical inaccessibility, such as a courthouse closure caused by weather or other conditions but have broadened the definition to include reasons other than weather, such as an outage of the electronic filing system. In this instance, the Tax Court says that inaccessibility does *not* include "problems that are unique to an individual." **(Code §7451; Filing Deadlines)**

Comment: Taxpayers have 90 days from the date of an IRS deficiency notice to pay up or petition the Tax Court for relief. He claimed that he started the process before midnight, and that it was the computer system that was faulty. The Court found the system to "be fully operational" on that day, and any problems he encountered "were unique to him and were *not* systemwide."

Comment: This is how it used to be with most every other IRS filing deadline, such as having to make an S corp election on **Form 2553** by the "15th day of the third month" of the current tax year in order for the election to be retroactively effective.

Late-Filed Tax Court Petition Deemed Void (*Nutt*, 160 TC No. 10 (5/2/2023))

The Tax Court affirmed that the electronic filing of a Tax Court petition *five minutes late* in a deficiency case was fatal.

Taxpayers normally have 90 days from the date of an IRS deficiency notice to either pay the outstanding tax liability or petition the Tax Court for relief. The taxpayers in this instance who lived in Ala. e-filed their petition at 11:05 p.m. Central Time on day 90. But it was 12:05 a.m. Eastern Time on day 91 in D.C., which was the location of the Tax Court's main office and the office of its clerk. The Tax Court agreed with the IRS and dismissed the couple's case since they e-filed the petition too late. According to the Court, the last minute of a last day for e-filing with the Court, which in this situation was day 90, was 11:59 p.m. Eastern Time. **(Code §6213; Tax Court Petitions)**

Code §8938 - Statement of Specified Foreign Financial Assets:

☞**Supreme Court Declines Certiori re: FBAR Penalties Violating 8th Amendment (*Toth v. U.S.*, No. 22-177 (12/22/2022))**

The Supreme Court has decided that it will *not* review a case to determine if foreign bank account reporting penalties are subject to the "excessive-fines clause" under the Eighth Amendment. It denied a petition for certiorari filed last September by Monica Toth, a grandmother against whom the IRS assessed a penalty of $2,173,703 for "willfully failing" to file an FBAR on her 2007 return. Toth had asked the Court to overturn the decisions of the 1st Circuit and the Massachusetts District Court, which both held that the civil penalties the government applied did *not* qualify for constitutional excessive-fine protections. **(Code §8938; FBAR)**

Comment: The taxpayer had inherited a Swiss bank account from her father who was a successful businessman. Her family fled Germany in the 1930s and she was born in Argentina, later immigrating to the United States in 1962, where she married and had four children. In 2011, she *retroactively* filed FBARs for previous years, as she allegedly was unaware of the U.S. foreign account **reporting rules** established by the **Bank Secrecy Act**. For the 2007 tax year, the IRS determined that the account information was "purposefully *not* disclosed," prompting the more severe penalty equal to half of the account balance.

☞**FBAR Penalties Still Owed After Death of Taxpayer (*Gaynor*, D.C., Fla. (9/6/2023))**

The District Court confirmed that FBAR penalties for "willful failure" to report foreign accounts survive the death of the account owner. The IRS had previously assessed millions of dollars in fines against a woman for willfully failing to report overseas accounts for 2010 through 2012. She subsequently died in

2021 without paying the outstanding amount. Her estate then attempted to claim the fines "were penal in nature" and should be abated upon death. The Court analyzed a number of factors and decided that the penalties "are remedial" and therefore survive the death of the taxpayer. **(Code §8938; FBAR)**

☞**FBAR Penalty per Account or Non-filed FINCEN? (*Solomon,* D.C., Fla.(10/27/2021))**

The issue before the court was whether the fine for nonwillful foreign account non-reporting apply per account, or per non-filed FBAR form? This is a highly-contested issue in several court decisions released thus far. The penalty for a person's "nonwillful failure" to report a foreign account is $10,000. But, earlier in 2021, a case in which the 9th Circuit Court of Appeals decided that the "penalty applies per missing FBAR form." And, many federal district courts follow this same approach, although not all. In this recent case, a U.S. citizen with several foreign accounts failed to report them on the FBAR form for 2004-10. After determining the late reporting was "nonwillful," the IRS assessed a $200,000 penalty based on the number of foreign accounts that he held and failed to report on (i.e., $10,000 x 20 violations). The district court here upheld that fine, but the taxpayer immediately appealed the case to the 11th Circuit Court of Appeals. **(Code §8938; FBAR)**

> **Comment:** The Supreme Court has now ruled that the penalty is "per axpayer" and *not* "per account."

Notes:

FROM CONSULTING CALLS:

Miscellaneous:

☞Pro-taxpayer "Change-in-use" Regs

What if the taxpayer changes the use to which the property is put sometime during its recovery period (i.e., before all of its basis has been depreciated)? To answer this question, the IRS has issued **regs** which dictate that the **recovery period would actually have to be switched at this point in time and the asset's remaining basis be recovered over this new time frame**. However, it is key to understand that the taxpayer is **permitted to elect out of these regs** and therefore **continue to write off** the asset's cost **over its original recovery period**.

> **Example: "Like-kind Exchange of Commercial Real Estate for Residential Real Estate"**
> A taxpayer owned a MACRS 39-year commercial building which was placed in service four years ago and for which there was still an adjusted basis of $500,000 remaining. He then exchanged it for an apartment building in a like-kind exchange where there was no boot (i.e., there was no realized or recognized gain in this "deferred ***Starker*** exchange). As a result, he would use the carryover basis of $500,000 for the initial basis of the apartment building.
>
> Under these proposed regs, since there was a "change in use" (i.e., going from a commercial to residential property), the rule would be that the apartment building would have to be depreciated now over a new "fresh start" period of 27.5 years using the mid-month convention as of the time that the new building was placed in service (i.e., which can be up to 180 days from when the LKE was originally done).
>
> **Comment:** In this example, it is to the taxpayer's advantage to have the "change-in-use" regs apply as opposed to electing out and having to continue depreciating the $500,000 carryover basis over the remaining 35 years that had existed for the former commercial building that the taxpayer owned.
>
> **Example: "Like-kind Exchange of Residential Real Estate for Commercial Real Estate"**
> A taxpayer owned a MACRS 27.5 residential apartment building which was placed into service 7.5 years ago and for which there was still an adjusted basis of $500,000 remaining. He then exchanged it for a commercial building in a like-kind exchange where there was no boot (i.e., there was no realized or recognized gain in this "deferred ***Starker*** exchange). As a result, he would use the carryover basis of $500,000 for the initial basis of the commercial building.
>
> Under these proposed regs, the taxpayer could opt to *not* have the normal "change-in-use" regs apply. As a result, "shoes depreciation" would apply and the carryover basis of $500,000 of the new commercial building could be written off over the 20 years that had remained on the residential building which he had previously owned. **(Code §168; Change-in-use Regs)**

☞Properly Depreciating "Mixed-use Property"

It is not unusual to have a retail establishment on the ground floor (i.e., street level) with the upper floors consisting of dwelling units such as apartments. Nevertheless, the property cannot be split for classification purposes (i.e., part of it being in the MACRS 39-year commercial real estate recovery class, with the remainder being 27.5-year residential property). Instead, an "80%/20% test" is employed **as of the date that the property is first placed into service**.

> **Comment:** This "80%/20% test" can best be explained by stating that if > 20% of the gross rents in a "mixed-use building" are derived from the commercial space, then it would be classified as

MACRS 39-year commercial real estate. This is in spite of the fact that most of the actual square footage might be allocable to the residential space in the building. In other words, it would be the gross rents and *not* the square footage which would control for MACRS classification purposes.

This can result in a building that has vacant retail (i.e., commercial) space when first purchased (i.e., and which is refurbished over the next few months) being grouped together with the residential units resulting in an overall MACRS 27.5-year life for the *entire* structure. Even when the retail space is eventually placed into service, the property's recovery period is still *not* split into residential v. commercial at that point in time. Nor, does it appear that the original 27.5-year recovery period has to now be reclassified into 39-year commercial property for the remainder of its life for depreciation purposes (i.e., **even if more than 20% of the gross rents were now being derived from the commercial space**), given that an election out of the "change-in-use" regs is properly made. **(Code §168; Mixed-use Real Estate)**

☞Determining an Asset's Basis

INTRODUCTION: Generally, an asset's basis, whether paid for in cash or other property (i.e., including intangible property such as stock or securities), is its cost for tax purposes per **Code §1001**.

Comment: IRS **Pub. #551** provides basic federal tax and recordkeeping information to determine the basis of property.

a. An asset's cost would include other associated costs such as amounts paid for **sales tax, freight charges**, along with any installation and testing costs.

b. An asset's cost would include any amount paid for in cash, borrowed amounts, other property and/or services.

Comment: Regarding the "basis" of an acquired asset, there has been some confusion where it has been purchased on credit. It makes no difference when a cash-basis taxpayer finances the cost of purchase (i.e., using a credit card, note payable, etc.). They do *not* have to wait until the balance on the credit card is paid off (for instance, in a later tax year). Suppose, with regard to the purchase of a building, should one taxpayer who pay cash for the entire purchase price be treated differently than one that secured financing from the seller and agreed to pay for the building over a 10-year period with a stated rate of interest? Or, a buyer who secures independent financing from a bank, getting a 30-year mortgage, and therefore pays the entire purchase price of the building immediately to the buyer but will now repay the bank over the ensuing 30 years?

Comment: The issue of "basis" is a bit more complex where leased property is involved with an option to purchase, with some of the rental payments being applied against the ultimate purchase price. It becomes a matter of facts and circumstances as to whether (and, when) a purchase v. lease finally occurs.

c. Acquisition costs for real property would include broker's commissions, but *not* real estate taxes which are treated under **Code §164(d)** as being imposed on the selling party (and, for which, they will be taking a current deduction).

Comment: The calculation of an asset's basis might be more involved when it is being created (e.g. built) by the taxpayer. Take, for example, real estate (e.g., a condo project) which starts with a feasibility study and zoning hearings. These initial steps alone might take several years. Then, there are marketing and cost studies, along with required EPA reviews. Finally, preliminary legal, marketing and accounting costs have to be factored in. The **key determination is when has the "development phase" commenced** where the taxpayer only held raw land before (and was, perhaps, deducting any taxes and interest on an on-going basis)? Once it starts, though, all of the aforementioned costs (except interest and taxes) have to be capitalized. And, **when the taxpayer actually breaks ground to start the construction process (i.e., the "shovel test"), then even the interest and taxes get capitalized from that point forward.** Finally, it is only when these units of inventory (i.e., condos) get sold that these costs are recouped as part of the basis of the assets being sold.

Comment: A study should be made, however, of **Rev. Proc. 2023-09** and the election thereunder to include the cost of "common improvements" (even those scheduled to be built in the ensuing 10 years) in the basis of lots (or, homes built on those lots) currently being sold using the **"Alternative Cost Method."**

☞Safe Harbor for Small Taxpayers - "Small Building Exception" for Repairs & Improvements

Sometimes overlooked in the "repair regulations" (along with the ability to immediate expense under either Sec. 179 or the bonus depreciation rules) is this exception where up to $10,000 of capitalized improvements can be written off annually. Landlords oftentimes have difficulty telling the difference between an "improvement" v. a "repair" and this has led to many landlord disputes with the IRS over the years. However, with this exception, life is getting a little easier for many residential landlords. The bottom line is that the IRS has established a new "safe harbor rule" that allows for the current deduction of many expenses that might otherwise be considered improvements.

Comment: Keep in mind that taxpayers also have the option of taking an immediate deduction for the cost incurred for the acquisition of "de minimis" assets. That is, those which are separately stated on an invoice and which do *not* exceed $2,500 apiece ($5,000, if the taxpayer maintains "applicable financial statements"). For instance, a **Schedule E** landlord purchases $30,000 of furniture, fixtures, appliances, rugs, etc. for his rental property where most of the items do *not* have a sales price exceeding $2,500. If elected, he could simply deduct the cost of these items immediately on **Schedule E** (i.e., without the need to use either bonus depreciation or Sec. 179 immediate expensing).

Comment: The use of the TPR "*de minimis*" exception would also avoid the cost of such assets being included in the overall $1,160,00 in 2023 cap on **Code §179** immediate expensing, or the $2,890,000 in 2023 phaseout threshold. More importantly, if the cost of a new asset is written off as a repair (v. being capitalized and then deducted using either **Code §179** immediate expensing or bonus depreciation), then there will be no issue with regard to any **Code §1245** or **Code §1250** depreciation recapture when it is ever disposed of in a taxable sale or exchange. Nevertheless, pursuant to **Reg. §1.263(a)-1(f)(3)(iii)** since the asset's cost was charged off as a "repair," should there be any gain on the disposition of these expensed assets, it would still be characterized as being all *ordinary* (v. Sec. 1231) gain.

Comment: The "safe harbor for small taxpayers" (SHST; **Reg. §1.263(a)-3h)** took effect at the start of 2014. Given certain qualifications are met, expenses for repairs, maintenance, improvements, and other costs for business real property, including rental property owned by landlords may be deducted up to an annual limit of $10,000.

Comment: With the restrictions relating to QIP being limited to the interior of commercial (v. residential) buildings, along with Sec. 179 or bonus depreciation *not* being available for either 27.5- or 39-year real estate improvements, this "small building exception" might be the perfect means by which smaller landlords can ignore the distinction between a "repair" v. a capitalized improvement when seeking to currently deduct certain building related costs.

<u>Exception Only Available for "Smaller Landlords</u>:" As the name implies, the SHST is intended to be used by business owners with "relatively small businesses." As a result, there are strict limits on the value of buildings that may qualify under the safe harbor, as well as on the annual amounts the building owners can spend and earn. The bottom line is that taxpayers are *not* permitted to use this safe harbor in any year any of these limits are exceeded. But, given these annual limits are *not* exceeded, the SHST can be used for any number of rental buildings or units (i.e., you are *not* limited to just one property).

<u>$1 Million Building Value Limit</u>: The SHST may be used only for buildings (including condos and coops) with an "unadjusted basis" of $1 million or less. As a result, it cannot be used for many larger apartment buildings or other more expensive rental buildings. "Unadjusted basis" usually means a building's original cost (i.e., its cost basis), *not* including the cost of the land and you do *not* subtract the annual amounts you deduct for depreciation. However, you would add the value of any improvements that you make to the building while you own it and that you are depreciating along with the rest of the building.

<u>Annual Expense Limit</u>: A landlord may use the SHST only if the total amount paid during the year for repairs, maintenance, improvements, and similar expenses for a particular building does *not* exceed the *lesser* of $10,000 or 2% of the unadjusted basis of the building. This limit is determined on a building by building basis (e.g., if you own three rental properties, you would apply the limit to each building separately). The "2% of the unadjusted basis" rule means that a building with an original cost, for instance, of greater than $500,000, but *not* more than $1,000,000, will still have the $10,000 annual limit. Again, the limit is applied on a per-building basis. So, if you own two or more rental buildings, you may be able to use the SHST for some, but not for other properties.

<u>Annual Income Limit</u>: Finally, to qualify for the SHST a landlord must have "average annual gross receipts" of no more than $10 million during the three preceding tax years. Gross receipts include income from sales (unreduced by cost of goods), services, and investments. But, this restriction should not present a problem for smaller landlords.

> **<u>Comment</u>:** This "average gross receipts" limit of $10 million has *not* been adjusted for inflation and is different than the $27 million "average gross receipts" test for "qualified small businesses" for purposes of **<u>Code §163(j)</u>**.

<u>Claiming the STSH</u>: The "small taxpayer safe harbor" must be claimed each year by filing an election with a timely-filed tax return, including extensions. And, whether to claim this exception in a given tax year is entirely up to the taxpayer, while it can be claimed on some buildings/properties and not others. There is no specific IRS form for making this election. Instead, an appropriate statement identifying which buildings/properties should be included, along with the amounts expensed should be attached to the return. If the rental property covered by the SHST is owned by a partnership, limited liability company, or S corporation, the election must be made by the business entity, *not* by the individual partners, LLC members, corporate shareholders. But, once this annual election is made, it may *not* be revoked for the year it covers.

> **<u>Example</u>:** A taxpayer owns a single family home that he rents out. It has a $300,000 unadjusted basis (i.e., the original purchase price ignoring the allocable land cost was $300,000). During the current tax year, he paid $400 to a plumber to fix a leak, replaced a window for $800, as well as the water heater for $1,500. He would qualify for the "small taxpayer safe harbor" because the $2,700 spent on repairs, improvements, and maintenance during the year is less than 2% of his building's unadjusted basis (2% x $300,0000 = $6,000). In other words, by filing an election to use the SHST, the taxpayer may currently deduct the entire $2,700 on **Schedule E**.

☞Sec. 179 Recapture v. Sec. 1245 Depreciation Recapture

Distinguishing between Sec. 179 recapture (which does *not* necessitate the sale or exchange of the assets; only a drop of its "trade or business use" to 50% or below) v. Sec. 1245 recapture (which would involve the actual disposition of the underlying asset, including an intangible asset such as goodwill in a taxable sale or exchange).

> **Comment:** Some taxpayers will argue that a drop in the business use to 50% or less of an asset will *not* cause any recapture if *bonus depreciation* had instead been taken (v. Sec. 179 immediate expensing). For example, a taxpayer buys a "heavy vehicle" and, after just a few years, converts it completely to personal purposes (e.g., the car is given to a family member of the business owner/employee). They contend that if bonus depreciation had been taken instead of Sec. 179, any depreciation recapture would only occur upon a taxable sale or exchange of the vehicle. Nevertheless, the Service takes the position in **INFO 2004-0193** that any bonus depreciation taken on such a vehicle (along with any accelerated depreciation over what would have otherwise been allowed using the S/L method over the ADS classlife) would also be subject to the recapture rules **resulting from a mere change in use** (i.e., where the business use drops to 50% or less).

> **Comment:** Some taxpayers had insisted that since "heavy vehicles" are *not* subject to the luxury car rules contained in **Code §280F**, any recapture should only apply to the Sec. 179 amount. However, in the opinion of the IRS, these SUVs are nonetheless "listed property" under **Code §280F(d)(4)(A)(ii)**, and, therefore the *remainder* of the provisions of **Code §280F** still apply.

☞"Catching Up" on Missed Depreciation

Normally, you "catch up" on missed depreciation (including bonus depreciation, if applicable) by filing **Form 3115** for the current tax year as opposed to filing an *amended* return (which might *not* even be possible if the statute of limitations has passed). The one exception is where the asset affected has been disposed of in a prior year and the infamous "allowed or allowable" approach to depreciation comes into play as to the correct adjusted basis to use on **Form 4797** (i.e., regarding the determination of overall gain or loss on the sale or exchange). We all know that the correct basis has to be used. So, it behooves the taxpayer to file **Form 3115** to catch up on any depreciation *not* otherwise claim (for example, because there was a misclassification of the asset and the use of an improper MACRS recovery period). And, **Rev. Proc. 2023-8** permits this very thing to be done.

> **Comment:** Compare this approach dealing with "catching up" on missed depreciation deductions with instead claiming Sec. 179 where an amended return is the only way to immediate expense an asset which had *not* been done when it was first placed into service. For instance, when a cost seg study is done and a number of 5- or 7-year assets are "discovered" (i.e., they were originally included in the basis of commercial or residential real property), there is now an opportunity to file an amended return (if the tax year is still open) and make an immediate expensing election on **Form 4562** (given that the overall cap on Sec. 179 has *not* been exceeded in that prior tax year).

> **Comment:** The "automatic consent" revenue procedure is annually updated and **Rev. Proc. 2023-8** is the latest version. Furthermore, **Rev. Proc. 2002-19** requires that this "negative adjustment" all be taken in one tax year (i.e., even if this **"Sec. 481(a)"** exceeds $25,000). **(Code §168; Incorrect Depreciation)**

☞Deemed Partial Dispositions of Real Estate Assets

The IRS has issued regs that change several of the rules for dispositions of MACRS property. Included among the changes are rules that no longer treat structural components of a building as *separate* from the rest of the building. Nevertheless, the rules do provide that *partial* dispositions generally can be treated as dispositions for tax purposes (i.e., and, therefore, be able to claim an ordinary Sec. 1231 loss on **Form 4797** for the remaining undepreciated basis of the asset being disposed of).

Comment: But, these **Code §168** regs only apply to MACRS property. As a result, if the taxpayer's books and records show (i.e., on **Form 4562**) that the partially disposed asset was depreciated under a *pre-MACRS method* (i.e., for assets placed in service prior to 1987), a loss is *not* permitted to be recognized on the partial disposition. The apparent reason that the IRS does *not* allow Sec. 1231 losses for pre-MACRS is supposedly real property placed into service before 1987 would be fully depreciated as of this point in time. And, capitalized improvements made on real property originally placed into service before 1987 would otherwise be treated under the current MACRS rules for cost recovery purposes (i.e., since they are capitalized in the current year that the improvement is being made, along with the fact that an immediate write-off could be claimed as a "repair expense" or as a "qualified improvement property" asset).

Comment: As mentioned above, these final "interpretative" TPR regs take a "component depreciation" approach insomuch as they allow for the breakdown of a building into "building systems" which can now be treated as disposed of when scrapped (e.g., old HVAC/roof is replaced), even though there has been no actual "sale or exchange" of the overall building.

Comment: These changes eliminate the need to make the "general asset account" (GAA) election for buildings. This is a departure from the temporary regulations where you were required to write off the undepreciated basis of a building component at the time that it was replaced. In fact, the replacement of a *single* window under the temporary regs required you to deduct its undepreciated basis (assuming you could determine it) while capitalizing the cost of the new window. And, the only way around this was to put the building into a GAA. And, given that a GAA election is now *not* needed, the IRS apparently allowed for these elections to be revoked without any adverse tax consequences.

Comment: If you do decide to utilize the "partial disposition rules," the election is made simply by reporting a Sec. 1231 ordinary loss on **Form 4797** of the taxpayer's return. But, if a taxpayer takes this write-off, the related replacement costs have to be capitalized. Furthermore, if the partial disposition involves a situation occurring *before* 2014, **Form 3115** should have been filed to instead claim this "negative" Sec. 481(a) adjustment, even for "small taxpayers."

Comment: If a taxpayer was dealing with a "duplication" on depreciation with regard to the structural components of a building (e.g., multiple roofs or HVACs), then **Form 3115** would be filed to correct this "erroneous" method (i.e., using **"Code #7"** on page 1 of **Form 3115**) and taking a "negative Sec. 481(a) adjustment (i.e., as an "Other Deduction" on page 1 of their tax return). But, what about future tax years? For instance, suppose a taxpayer is correctly depreciating the original roof on a building placed into service several years ago and now decides to completely replace it (i.e., *not* just merely putting new shingles or rubber membrane). It would be arguably incorrect to now be depreciating "two roofs." But, as opposed to "correcting an erroneous method" being used on previously filed tax returns, the taxpayer would simply be seeking to take a Sec. 1231 ordinary loss on **Form 4797** with regard to the "deemed disposition" of the "old roof." To reiterate, this latter situation would *not* involve the filing of **Form 3115** to effectuate a "change in accounting method."

Comment: Once again, this could present a valuable opportunity for taxpayers to go back and review their depreciation schedules to determine what "ghost assets" remain on their depreciation schedule. And, for some clients, where there were "improvements" that were required to be capitalized, there could be significant deductions for the undepreciated basis of the assets deemed disposed of and which would now be available.

Comment: One of the major concerns was that taxpayers may only get one chance, if they decide to "clean up" their depreciation schedules. And, this was made clear with the transitional guidance on the **Form 3115** requirements which were the focus of **Rev. Proc. 2015-20**. As a result, it appears that "retirement studies" and the resulting disposition deductions will *not* be treated as a "change of accounting method" which will require IRS pre-approval. But, if the taxpayer opts *not* to take this "clean-up approach," there is always the risk that the IRS might imposed the "allowed or allowable" mandate, thus denying the taxpayer the right to continue deducting the remaining unadjusted basis of the disposed of asset (e.g., old roof, HVAC, etc.). But, in **Notice 2017-6**, the IRS has extended the provision which allows for automatic tangible property method changes. **(Code §168; Deemed Dispositions)**

☞Loss Deduction Delayed for Closing Facility

When a taxpayer closed its computer operations, it wrote down the value of the facility to the amount determined by a broker, which resulted in a tax loss. The facility was then vacant until it was sold to another tenant in the building. In a field service advice (**FSA 200141026**), the IRS concluded that taxpayer should *not* be able to claim a loss deduction when it first closed the facility because "it was *not* retired or permanently withdrawn from usage" (i.e., there had *not* been a realization event for tax purposes upon the initialization retirement of the property). Furthermore, since the building was no longer in service (i.e., this was *not* just a "temporary" closure), depreciation on the closed facility should also be suspended. **(Code §168; Idled Facilities)**

Comment: A company had housed some of its computer operations in this property it owned. Then, to save money, the facility was closed and the space was put up for sale. Eventually, the property was sold in a subsequent tax year. But, the company felt that it should be entitled to claim a tax loss in the year that it originally stopped using the building for business purposes. The IRS' contention was that the company continued to own the property after computers were moved out (i.e., even if it was *not* still "in service" for depreciation purposes), and the space had more than a nominal value when the business use ceased.

Example: Tony's Pizzeria was a small establishment which served take-out pizzas and other Italian specialties. However, it was successful in obtaining one of the few liquor licenses in town where another proprietor decided to retire and closed his restaurant. With the ability to now serve alcohol, Tony's decided to upscale its menu and to re-open as a full-service restaurant. During the current tax year, Tony's decided to do extensive renovations and even purchased the business located immediately adjacent to it (i.e., an retail clothing store) breaking through its walls to triple its current restaurant space. As a result, Tony's was only open for two of the months during its current tax year. Besides having to capitalize these improvements as either fixtures or real estate (i.e., and recovering their basis through depreciation once the premises where re-opened for business), Tony's would have to suspend current depreciation write-offs for the assets that were already in service and for which it had been taking a deduction until such time that the restaurant was operating once again. One could argue that they were "temporarily idle," but it is clear that the assets are *not* "available for use" in that trade or business while it is shut down (unlike the computer facility mentioned above).

Example: Jack owned a number of residential rental properties and was always on the lookout for a adding to his investments. When he did locate a suitable property, it was usually in the state of disrepair, but that is why he was able to successfully negotiate such low acquisition prices for the buildings. Once acquired, Jack would gradually wait until the leases of any tenants had expired and would commence extensive renovations on those units. But, as a result, while these units might be out of service for up to six to nine months while the renovations were taking place, Jack would be precluded from taking any depreciation write-offs on the allocable basis of this space or the unit or building in question.

Example: Eric locates a commercial building on the main street of the town in which he lives and acquires it as an investment. It has retail space at the street level and residential apartment units on the second and third floors. As of the date of purchase, the six apartments are fully occupied, but the retail space on the first floor is vacant as it is in the need of extensive renovations and certain other improvements to bring it up to code. Assume that the purchase of the building is made in November of the current tax year, but that the first floor space is *not* ready for occupancy until May of the following year. It is clear that the residential space has been "placed into service" for the current tax year. And, since more than 80% of the rents are being derived from residential units, the appropriate recovery period would be 27.5 years. **Code §168(e)(2)(A)(I)** defines "residential rental property" as any building or structure if **80 percent or more** of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. Therefore, an allocable portion of the purchase price paid for this portion of the building can be listed on **Form 4562** and depreciated (i.e., given the mid-month convention, Eric would receive 1.5 months of depreciation). However, the basis allocable to the land and the unoccupied space on the first floor would *not* be allowed any depreciation. Only when the renovations were complete to the first floor and the space was otherwise available for rent could Eric add this to the basis of the depreciation asset already in service.

Comment: What might now be an issue is whether Eric would have to switch the adjusted basis remaining in the building (i.e., the original portion of the purchase price paid *not* allocable to the land) over to 39 years given that **more than 20% of the overall rents** were coming from this retail (i.e., commercial) space. For resolution of this issue, it is necessary to examine the "change-in-use regs." **Unless Eric elected out of their application**, the remaining adjusted basis of the building would now have to be recovered over the normal 39-year recovery period. Furthermore, you would **never split the building into *two separate assets* for MACRS purposes** (i.e., 27.5 years for the residential portion and 39 years for the commercial space). And, what is clear is that any capitalizable (i.e., leasehold) improvements made to the first floor, in and of themselves, would be 39-year commercial realty to the extent *not* allocable to 5- or 7-year fixtures (i.e., determined by use of a cost segregation study and proper supporting documentation) **or, under the TCJA, otherwise meeting the definition of "qualified improvement property" as 15-year property (for purposes of claiming bonus depreciation).**

☞Depreciating Irrigation or Retention Ponds

A client had to put in a pond next to his commercial building as a back-up to the well water which would serve as an additional source of water in case of fire (and, at the insistence of his insurance underwriter). The question is how this capital improvement should be treated for tax purposes? When one puts in a parking lot (i.e., a surface lot as opposed to a multi-story parking structure) with lighting and sidewalks adjacent to a building, there is no question that these are "land improvements" which qualify as 15-year MACRS property. Even landscaping which adds to the beautification of the grounds surrounding a building would also qualify as "land improvements." Should a pond which was *not* originally on the property which would be used for added fire protection be considered any less of a "land improvement?" It would seem not and arguably this would be eligible as a 15-year land improvement. **(Code §168; Irrigation Ponds)**

Comment: Would not the same result occur where a land developer had to put in a retention pond for water run-off at the same time that the streets and sewer system was being put in? These are very common as the EPA sets even stricter guidelines for storm run-off and to prevent excess water from flowing into the neighboring properties as more and more farmland gets developed into residential home sites.

☞Other Important Depreciation Related Developments

The Service continues to insist that open-air parking structures are 39-Year MACRS property and *not* 15-year "land Improvements" (**LMSB4-0709-029**) And, the IRS did impose penalties where a taxpayer insisted on taking this position.

- Should pallets (v. other more permanent shipping containers) be inventoried and included as part of goods sold (i.e., as "incidental materials and supplies)? Or, are the items in question used over and over again and, therefore, should be capitalized as a separate asset class of their own.

- The Service is insistent that depreciation deductions or LKE treatment should be denied for equipment held for sale v. rent. What factors distinguish one situation from the other? **(CCA 201025049)**

- In what instances can "site lighting" be treated as 5- or 7-year macrs property instead of 15-year land improvements? (***PPL Corporation & Subsidiaries v. Commr.*, 135 T.C. No. 8 (07/28/2010)**)

> **Comment:** This issue often arises with retail businesses such as car dealerships which displayed most of their vehicles outside of the showroom.

- What happens to Sec. 179 carryovers when proprietorships (e.g., SMLLCs) covert over to multi-member LLCs, or corporate entities (or, vice versa)? The suspended Sec. 179 deduction will remain on the personal return, but the adjusted basis of the assets being transferred over to the entity will be fully reduced by the Sec. 179 deduction even if it might be some time before any tax benefit is received by the taxpayer on their Form 1040.

- Examine a recent case study on an IRS audit where the Service insisted that kitchen cabinetry and counter tops had to be capitalized as part of the residential real estate where an upgrade/renovation was done to an entire apartment complex.

- As more tangible personal property such as trucks and other equipment (as well as certain real estate assets) are held in a separate LLC and leased back to a related trade or business (often on a "triple net lease" basis), a Sec. 179 deduction can be denied to *noncorporate* lessor where only an *oral* lease arrangement existed (i.e., because the taxpayer could *not* prove that the lease term was less than one-half of the otherwise allowed MACRS recovery period for these assets). **(*Ross Thomann*, TC Memo 2010-241(11/1/2010))** Furthermore, the IRS appears to be fairly adamant that rental income received pursuant to a "triple net lease" will *not* qualify as "Sec. 162 T/B income" for purposes of the Sec. 199A deduction.

- The courts have continue to confirm that covenants-not-to-compete associated with stock sales are always to be treated as Sec. 197 intangibles and therefore amortized over 180 months. **(*Recovery Group, Inc.*, TC Memo 2010-76 (4/15/2010))**

> **Comment:** Would monies received under a covenants-not-to-compete be considered another source of "unearned income" so as to make it subject to the new 3.8% Medicare surtax (i.e., on **Form 8960**)? As with alimony, gambling winnings, COD income, among others, it would *not* appear that such payments would constitute "net investment income" (even though it is technically a source of "unearned" income) as long as the former business owner had been "actively involved" in day-to-day management, but the IRS has *not* specifically come out and clarified this.

- A taxpayer was denied a deduction for the balance of unamortized goodwill where at least some of the other intangible assets of an acquired business still existed. Instead, the business had to take the basis of the unamortized goodwill and re-allocate it to the remaining intangible assets, with a write-off over the remainder of the 15-year period. (**CCM 20111101f**)

- A CPA who had previously sold his CPA practice, and then bought it back less than five months later due to the buyer's illness, was entitled to, once again, amortize the basis of any reacquired "goodwill assets" under **Code §197** even if the goodwill had *not* been amortizable when he formerly owned the practice. (***Fitch*, TC Memo 2012-358 (12/26/2012)**)

- The Service has released **Rev. Proc. 2011-14** which has made additional changes to the automatic consent procedures to be used when applying for a change in a taxpayer's accounting method. In addition, there are also **Rev. Procs. 2014-16** and **2015-13** which are to be used in obtaining "automatic consent" for **Form 3115** requests involving the "repair v. capitalization" regs (along with continued updates to the "automatic consent" revenue procedure each year). So, for any **Form 3115, "Change in Accounting Method"** being filed always check for the latest "Automatic Consent" IRS revenue procedure and although not technically necessary, list this reference in "red" at the top of **Form 3115** so the Service will know that no fee should be charged for this "change request" and also they would *not* have any discretion in granting such a request.

Comment: **Rev. Proc. 2021-34** is the latest version to be used for "automatic consent."

- Are we missing opportunities to use *corporate* entities to make stock purchases (i.e., instead of allowing individuals to buy the stock) where a "Sec. 338(h)(10) election" might be available (especially with purchases of S corp v. C corp stock)? Remember that this step-up of the inside bases of the assets deemed purchased would be eligible for Sec. 179 immediate expensing (along with bonus depreciation since the "original use" requirement was dropped for assets deemed acquired after 9/27/17).

☞**What to Expect When Requesting Relief from IRS Appeals Office**

If a taxpayer disagrees with an IRS decision, they may be able to avoid the time and expense of a court trial by asking the IRS Independent Office of Appeals to review their case. This office is separate from the rest of the IRS. When Appeals officers review cases submitted by taxpayers, they meet with taxpayers informally and consider their position and the IRS's position in a fair and unbiased manner.

Overview of IRS Appeals Process: According to the IRS, the following summary is what taxpayers need to know if they want to appeal their case:

1. To submit an appeal request, taxpayers mail their request in writing to the office that sent them the letter with their appeal rights. For information on filing a formal written protest or a Small Case Request, taxpayers should review **IRS Pub. 5**, **Your Appeal Rights and How To Prepare a Protest If You Disagree**. The IRS function that receives the request will consider the taxpayer's protest and attempt to resolve the disputed tax issues. If that office cannot resolve the taxpayer's issues, they will forward the case to Appeals for consideration.

2. Once the request is with Appeals, the Appeals officer contacts the taxpayer within 45 days by mail to schedule an informal conference to review the taxpayer's situation. Appeals conducts conferences by phone, in person and by video. Taxpayers may choose which type of conference they prefer.

3. At the conference, the Appeals officer discusses with the taxpayer the law as it applies to the facts of the case, including court rulings on similar cases.

4. If a taxpayer has *not* heard about their appeal and it has been more than 120 days since they filed their request, taxpayers can ask for a status update by contacting the IRS exam or collection office they worked with last.

5. If the taxpayer sends new information or documents to Appeals, the Appeals officer may need to send the case back to the original IRS function to review the new information. Appeals will *not* raise new issues or reopen issues agreed to by the taxpayer or the IRS except in cases of potential fraud or malfeasance.

6. Appeals officers review the facts, the law, the taxpayer's comments, and information presented by the taxpayer and IRS exam or collection office before they make a final decision. They will also explain to the taxpayer the reasons for the decision and their options. Generally, there are three outcomes of an appeal:

a) In the IRS' favor: If the facts and laws support the government's position, the Appeals officer recommends that the taxpayer concede and give up the issue.

b) In the taxpayer's favor: If the law and facts support the taxpayer's position or courts have ruled in favor of taxpayers in similar cases, the Appeals officer recommends that the IRS concede and give up the issue.

c) Compromise: The Appeals officer may recommend a compromise when the facts or laws are unclear, or the courts have made different rulings on similar cases. In this situation, Appeals may recommend a settlement where the taxpayer pays a percentage of the tax due. **(Misc.; IRS Appeals)**

Comment: Keep in mind that interest continues to add up on any unpaid balance a taxpayer owes as Appeals reviews a case.

Comment: The IRS has limited resources and often looks to set a precedent when presented with the clearest set of facts which support their position. So, when the law is obscure or the amounts involved are not that significant, they will look to resolve the case in the fairest way to both the government's and taxpayer's point of view.

☞**Key Facts About IRS Offers-in-Compromise**

Lacking the funds to pay off an outstanding tax liability, resorting to making an "offer-in-compromise" might be a useful alternative. There are two separate payment options: (1) Offering a lump-sum cash settlement which requires an up-front 20% down payment, with the remaining balance to be paid in five (or, fewer) installments within 5 months of when the taxpayer's offer is first accepted; or (2) Making "periodic payments" that require the first payment be made when the offer is accepted by the IRS, with the remaining balance being submitted in monthly installments over a period of 6 to 24 months.

One key requirement *before* any offer-in-compromise is made to the IRS is to ensure that all tax returns required to be file have been submitted. Otherwise, the Service will reject any offer, return the application and the filing fee paid, while retaining the first installment payment and applying it to any outstanding tax liability the taxpayer might otherwise owe.

It should be noted that if the taxpayer (or, a business applicant) has meanwhile filed for bankruptcy, they are not eligible for making an offer-in-compromise. The Service has recently updated it publication (i.e., Form 656-B booklet) which sets out the rules and forms needed to make an offer. And there is an "**online tool**" which the IRS had developed to check for the taxpayer's eligibility with regard to an offer-in-compromise. **(Misc.; Offers-in-Compromise)**

Comment: Special care should be taken to avoid the "O-I-C scams" (i.e., "compromise mills") that promise to settle a taxpayer's debt to the IRS at a deep discount. They advertise on TV and radio and charge large up-front fees while churning out OIC applications that many of their clients couldn't possibly afford.

☞**Alternatives for Taxpayers Lacking Resources to Pay Outstanding Debts**

The IRS has some resources to assist such taxpayers, including temporary collection delay, short-term payment plans, and installment agreements. Another option would be to submit an offer-in-compromise, where taxpayers can settle their federal income tax debts for less than what is owed. An IRS **website** sets out more detailed information on these various choices. Or, taxpayers can directly contact the Service and use its voice bots to set up a payment plan or to change an existing one but your identity will have to be authenticated. **(Misc.; Tax Liabilities)**

> **Comment:** Individuals with large outstanding unpaid tax balances will soon get some special attention from the IRS. Revenue officers will begin compliance sweeps of these deadbeats who owe large amounts of back taxes and have thus far ignored the IRS's outreach to settle the balances. Also being launched is a plan to have revenue officers conduct in-person visits with individuals who received income in excess of $100,000 but failed to file returns.

☞**Responding to IRS CP2000 Notices**

If a client has filed their return and received a CP2000 notice in response from the IRS in the mail, how should we assist them to respond? These letters are intended to let the taxpayer know that the Service computers have uncovered a discrepancy between income and deductions that were reported on the tax return when compared to third-party information returns, such as **Forms W-2**, **1099** and **1098**. The first step would be to go over the client's records again. If the records are in agreement with the proposed changes on the **CP2000**, sign and date it, and return the form with any payment otherwise due. If a joint return was originally filed, *both* spouses need to sign the response form. If the client is unable to pay the full amount, an installment agreement should be requested from the IRS on **Form 9465**. Interest will accrue, though, until the amount is fully paid.

On the other hand, if the client does *not* agree with the proposed changes on the **CP2000**, check the appropriate box on the form, send it back to the IRS with a written explanation, and attach copies of any documentation that the client has to support their position. A appropriate phone number should also be included so that the IRS can contact you as the client's professional advisor if needed. The most important thing is to respond in a timely manner, generally within 30 days of the date on the letter. But call the Service to request more time if you need it. Just do *not* ignore the **CP2000**. **(Misc.; IRS Notices)**

☞**Responding Properly to IRS "Math Error" Notices**

One of the most important things is to respond in a timely manner if the taxpayer decides to dispute an IRS math error notice. These notices are meant to inform taxpayers of any math or clerical errors on their returns which IRS has in turn corrected. There is a critical time limit of just 60 days from the issue date of the notice to request that the adjustment be abated. And if this is how the taxpayer responds, the IRS is *required* to abate it. But the Service can then choose to do an audit if it insists that the taxpayer still owes the tax and issue a notice of deficiency. If the client disagree with a math error adjustment and they do *not* respond within 60 days, then the taxpayer is deemed to have essentially conceded the error and, except in limited circumstances, forfeited their ability to petition the Tax Court to contest it. The taxpayer is still allowed to pay the balance and file a lawsuit in a federal district court to challenge the Revenue Service's position. **(Misc., Math Error Notices)**

☞**Tax Guidelines for New Business Owners** (**Tax Tip 2023-59**)

> **Comment:** Although these new business clients should be also seeking the help of a tax professional to get their operation compliant with the various tax requirements, this "Tax Tip" might provide a good start to help make them become aware of these rules.

The IRS has released this "online learning opportunity" for small business owners entitled the "Small

Business Virtual Tax Workshop." It is intended to help business owners "learn how to navigate their federal tax responsibilities." The Service touts this workshop as "an easy and convenient way for both new and experienced small business owners to learn or review topics relevant to their business."

Some of the topics covered include:

- **Federal taxes and your new business**

- **Schedule C and other small business taxes**

- **Filing and paying taxes electronically**

- **Business use of your home**

- **Federal taxes when hiring employees or independent contractors**

- **Managing payroll to withhold the correct amount of taxes**

- **Tax deposits and filing a return to report payroll taxes**

- **Hiring people who live in the U.S. who are *not* citizens**

> **Comment:** Each lesson contains hyperlinks to more specific topics within that lesson. Viewers can also pause and bookmark lessons so they can review more detailed information later.
>
> **Comment:** These videos might also be useful for newer members of the tax department to review. **(Misc.; IRS Tax Tips)**

☞**IRS Guidelines for Business Terminations (Tax Tip 2022-122)**

The Service has come out with a useful "Tax Tip" for those business clients who have decided to close their doors and file that final tax return. However, there are a few things business owners need to do before they close down their business. Obviously, they need to fulfill their federal tax responsibilities. It is also important to notify the IRS of their plans.

The IRS has stated that business owners take these steps when closing a business:

- File a final tax return and related forms: The type of return to file and related forms depends on the type of business.

- Take care of employees: Business owners with one or more employees must pay any final wages or compensation, make final federal tax deposits and report employment taxes.

- Pay any taxes owed: Even if the business closes now, tax payments may be due next filing season.

- Report payments to contract workers: Businesses that pay contractors at least $600 for services including parts and materials during the calendar year in which they go out of business, must report those payments (i.e., on **Form 1099 - MISC**).

- Cancel EIN and close IRS business account: Business owners should notify the IRS so they can close the IRS business account.

- Keep business records: How long a business needs to keep records depends on what is recorded in each document.

The IRS **website** has information to help guide business owners through the process of shutting down. Small businesses and self-employed taxpayers can find additional information including: (1) What forms to file; (2) How to report revenue received in the final year of business; and (3) How to report expenses incurred before closure.

> **Comment:** Business owners can also get helpful information on declaring bankruptcy, selling their business and terminating retirement plans. **(Misc.; Business Terminations)**

☞**Steps Sole Proprietors Should Take When Closing Their Business (IRS Pub. 5447)**
The IRS has provided on its **website** guidance to sole proprietors on the specific steps they should take when closing (i.e., liquidating) their business.

> **Comment:** Due to the economic fallout caused by the current Covid-19 pandemic, this might unfortunately be a more common occurrence for many businesses going forward unless more stimulus payments or PPP loans are approved by Congress.

An employer who otherwise has employees and who goes out of business or ceases to pay wages must file *final* employment tax returns (e.g. **Form 941, Employer's Quarterly Federal Tax Return or Form 944, Employer's Annual Federal Tax Return, and Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return)**. These returns must be marked "final return." (**Reg. §31.6011(a)-6(a)(1)**)

On **Form 941**, this is done by checking the box in **Part 3** and entering the date the employer last paid wages on line 17. (**Form 941, Instructions**)

On **Form 944**, it is done by checking the box in **Part 3** and entering the date the business closed or last paid wages on line 14. (**Form 944, Instructions**)

On **Form 940**, it is done by checking **Box d** on page 1 of the form. (**Form 940, Instructions**).

A final **Form 941** must be accompanied by a statement indicating where the employment tax records will be kept and the name and address of the new owner of the business, if any. If there was no sale or transfer of the business, or the employer does *not* know the name of the person who bought or acquired the business, that fact should be included in the statement. (**Reg. §31.6011(a)-6(b)**)

Form 1099-NEC, Nonemployee Compensation is used by businesses to report payments to non-employee workers (i.e., independent contractors). A business must file a **Form 1099-NEC** with the IRS for each non-employee worker to whom the business paid $600 or more and provide a copy to the nonemployee worker.

Generally, a business that operates a "large food or beverage establishment" must file **Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips**. A large food or beverage establishment is a "food or beverage operation:"

a. That is located in the U.S.,

b. Where customer tipping of food or beverage employees is customary, and

c. Normally employed more than 10 employees on a typical business day during the preceding calendar year (the "10-employee test").

A "food or beverage operation" is any business activity that provides food or beverages for consumption on the premises (e.g. a restaurant or a bar), other than fast food operations. Generally, tipping is *not* considered customary in a cafeteria-style operation or if at least 95% of total sales (other than carryout) had a service charge of 10% or more.

Closing a Sole Proprietorship: A sole proprietor should take the following steps when closing the business:

1. If the business has one or more employees, the employer should file final employment tax returns and make employment tax deposits for the calendar year in which the business makes its final wage payments. Employment tax returns include **Form 940**, **Form 941** and **Form 944**.

2. The employer will also need to provide employees with **Forms W-2, Wage and Tax Statement**, and **File Form W-3, Transmittal of Income and Tax Statements**, to transmit **Form W-2, Copy A**, to the Social Security Administration (SSA) for the calendar year in which the business makes its final wage payments.

Forms W-2 can be filed electronically using the **SSA's Business Services Online (BSO)** filing portal. Electronically filed **Forms W-2** do *not* need to be transmitted using a **Form W-3**. Federal tax deposits must be made using the Electronic Federal Tax Payment System (EFTPS). Both the BSO and EFTPS require registration before they can be used to file documents or make payments, respectively.

3. If the business paid any non-employee workers (i.e., independent contractors) $600 or more, it will need to provide them with **Forms 1099-NEC** and, if *not* e-filing its **Forms 1099-NEC**, the business will need to use **Form 1096, Annual Summary and Transmittal of U.S. Information Returns**, to transmit paper copies of **Forms 1099-NEC** to the IRS. **Forms 1099-NEC** can be filed electronically using the **IRS's Filing Information Returns Electronically (FIRE)** system.

4. If the business is a "large food or beverage establishment" and has tipped employees, the business should file **Form 8027** to report final tip income and allocated tips.

5. If the business provided its employees with a pension or benefit plan, the business will need to file a final **Form 5500, Annual Return/Report of Employee Benefit Plan**. **Form 5500** and **Form 5500-SF, Annual Return/Report of Employee Benefit Plan Short Form**, must be filed *electronically*. **Form 5500-EZ, Annual Return of One Participant (Owners and their Spouses) Retirement Plan**, cannot be electronically filed and, therefore, must be filed on paper with the IRS.

6. File the final **Schedule C/F**. With either **Form 1040** or **Form 1040-SR**, a sole proprietor should file a final **Schedule C** or **F** to figure any profit or loss from the business. A **Schedule SE, Self-Employment Tax**, should also be filed if any self-employment tax is due. If the sole proprietor sold all of the business assets, including any goodwill, they should also attach to the return **Form 8594, Asset Acquisition Statement**. If the sole proprietor sold separate business assets or property, they should attach to the return **Form 4797, Sale of Business Property**.

7. The business's account with the IRS should be closed. After all their returns are filed, the sole proprietor should send the IRS a letter with the business's complete legal name, employer identification number (EIN), and business address, explaining why the business wants to close its account. Include a copy of the business's **SS4 letter** containing its EIN assignment (also known as a **147C letter**). Send

the letter to: **Internal Revenue Service, Cincinnati, Ohio 45999**. All appropriate tax returns must be filed before the IRS will close the business's account. **(Misc.; Business Termination)**

Code §1221 - Capital Asset Defined:

☞**Ordinary Loss for Abandonment of Leasehold Improvements**

When, at the end of a lease term, the lessee decides to abandon leasehold improvement whose costs have *not* been fully recovered (i.e., under the MACRS system), a **Code §1231** loss can be claimed on Form 4797 for any remaining basis in the underlying assets. And, if this **Code §1231** loss exceeds any **Code §1231** gains for the tax year in question, then the excess is taken on page one of the taxpayer's return as an ordinary loss. **(Code §1231; Leasehold Improvements)**

> **Comment:** Remember that certain leasehold improvements (QIP) made after 12/31/17 may qualify for a 15-year write-off instead of the normal 27.5- or 39-year classification for real estate. More importantly, there might be little or no remaining adjusted basis in such assets given that Sec. 179 or 100% bonus depreciation was used to write of their cost. As a result, there might not be any "loss" when these assets are abandoned.

TCJA CHANGES/DEVELOPMENTS

INDIVIDUAL TAXATION:

☞Comprehensive Analysis of Eliminated "2% Miscellaneous Deductions"

The **TCJA** eliminated all "2% miscellaneous deductions" for tax years beginning in 2018 or later. However, it might come as a surprise as to how many different miscellaneous deductions will be affected by this change. The list is quite extensive as indicated in the summary below.

> **Comment:** Remember that the **TCJA** only eliminated "2% miscellaneous deductions" and did *not* impact the deduction of other miscellaneous deductions such as gambling losses (which are *not* subject to the "2% of AGI threshold").

- **Form 2106:** Unreimbursed employee business expenses

> **Comment:** This is why is makes sense to create (or, expand) an employer "accountable plan" where ordinary and necessary employee business expenses can be accounted for and reimbursed (i.e., so the employee does *not* have to seek to deduct them on their personal tax return).

> **Comment:** Unreimbursed employee expenses cannot be deducted on **Form 2106** unless the taxpayer falls into one of the following categories of employment: (1) Armed Forces reservists; (2) Qualified performing artists; (3) Fee-basis state or local government officials; and (4) Employees with impairment-related work expenses. But, even though **Form 2106** is still used to claim such expenses, the deduction is now shown on **Schedule 1, Line 11** as a "for-AGI" subtraction (i.e., instead of as a "2% miscellaneous deduction" which has now been eliminated on **Schedule A**).

- Appraisal Fees: Appraisal fees paid to estimate a casualty loss or the FMV of donated property

> **Comment:** An exception would be for appraisal fees incurred to evaluate casualty losses occurring in a "federally declared disaster area."

- Casualty and Theft Losses - Employment Related Assets: Damaged or stolen property used in performing services as an employee

- Clerical Help and Office Rent: Office expenses, such as rent and clerical help, paid in connection with a individual's investments and collecting taxable income on those investments

- Credit or Debit Card Convenience Fees: The convenience fee charged by the card processor for paying income tax (including estimated tax payments) by credit or debit card

- Depreciation on Home Computer: If a taxpayer uses their home computer to produce income (e.g., to manage their investments that produce taxable income), the depreciation of the computer for that part of the usage is no longer allowed.

- Excess Deductions of an Estate: An excess deduction resulting from an estate's total deductions (e.g., decedent's medical and funeral expenses) being greater than its gross income, in the previous tax year, are no longer deductible by the beneficiaries in the *final* year that the estate **Form 1041** income tax return is finalized.

> **Comment:** This is in spite of the fact that the **Instructions** to **Form 1041** (Cf. **Page 27**) have

failed to be updated for the **TCJA** and still indicate the "old" law where such excess deductions could be taken on **Schedule A** of the beneficiary.

- Fees To Collect Interest and Dividends: Fees paid to a broker, bank, trustee, or similar agent to collect taxable bond interest or dividends on shares of stock

- Hobby Expenses: Such expenses are no longer deductible and cannot be carried over to future profitable years of the "hobby business." (Cf. **"Not-for-Profit Activities"** in **Chapter 1** of [IRS Pub. 535])

- Indirect Deductions of Flowthrough Entities: Such entities include partnerships, S corporations, and mutual funds that are *not* publicly traded. Normally, deductions of flowthrough entities are passed through via the K-1s to the partners or shareholders (or, **Form 1099-DIV** for the mutual funds). But the share of the entity's investment expenses are no longer deductible.

- Investment Fees and Expenses: Investment fees, custodial fees, trust administration fees, and other expenses paid for managing investments that produce taxable income (e.g., management advisory fees).

> **Comment:** Costs incurred in holding raw land, for example, such as cutting grass and maintaining the property are investment related expenses which are treated as 2% miscellaneous itemized deductions and so are no longer deductible. And, being nondeductible, they can also *not* be capitalized as **Code §266** "carrying charges" which are instead added to the basis of the property. In other words, as discussed above, there is no exception similar to the one accorded for state and local taxes on investment property (i.e., with regard to the annual $10,000 SALT limitation).

- Legal Expenses: Legal expenses incurred in attempting to produce or collect taxable income, or that are paid in connection with the determination, collection, or refund of any tax

> **Comment:** On the other hand, expenses incurred to resolve tax issues relating to profit or loss from business (**Schedule C**), rentals or royalties (**Schedule E**), or farm income and expenses (**Schedule F**) remain deductible on the appropriate schedule. But, expenses incurred for resolving "nonbusiness tax issues" are 2% miscellaneous itemized deductions and are no longer deductible.

- Loss on Deposits: Ordinary losses on deposits in insolvent or bankrupt financial institutions

- Repayments of Previously-Included Income: Generally, repayments of amounts that were included in income in an earlier year are "2% miscellaneous itemized deductions" and can no longer be deducted.

> **Comment:** An exception exists where the amount to be repaid **exceeds $3,000**. Under **Code §1341** and the **"Claim of Right Doctrine,"** a *credit* (v. a deduction) against taxes could instead be taken at the option of the taxpayer. And, choosing the "credit treatment" would avoid the claiming a what would otherwise be a "2% miscellaneous deduction."

- Repayment of Excess SSBs: If the total amount shown in **Box 5** of all of a taxpayer's **Forms SSA-1099** and **RRB-1099** is a *negative* figure, a partial deduction of this negative figure that represents benefits included in gross income in an earlier year is allowed, if the figure is **more than $3,000**. On the other hand, if the amount is **$3,000 or less**, it is a "2% miscellaneous itemized deduction" and is no longer deductible.

- Safe Deposit Box Rent: Rent paid for a safe deposit box used to store taxable income-producing stocks, bonds,
or investment-related papers is no longer deductible (and, the cost was never deductible if it was only

used to store jewelry, other personal items, or tax-exempt securities).

- Service Charges on Dividend Reinvestment Plans: Service charges paid as a subscriber in a dividend reinvestment (DRIP) plan

- Tax Preparation Fees: Tax preparation fees on the return for the year in which you pay them are no longer deductible. These fees include the cost of tax preparation software programs and tax publications. They also include any fee paid for electronic filing of your return.

> **Comment:** Obviously, to the extent that tax prep fees can be allocated "above the line" (e.g., to the preparation of **Schedules C/E/F**, they remain deductible.

- Trustee's Administrative Fees for IRA: Trustee's administrative (i.e., custodian) fees that are billed separately and paid by the taxpayer individually in connection with their IRA

> **Comment:** There is also an extensive list of other nondeductible types of personal expenses found on **Page 193** of **IRS Pub. 17**.

☞**Are Clients Missing Out on Sec. 199A Deduction?**

According to a recent audit by the Tax Inspector General (TIGTA), some filers are "missing out on the Sec. 199A 20% qualified business income deduction." Self-employed individuals, farmers and individual owners of partnerships, LLCs, S corporations and other flowthrough entities are permitted to deduct 20% of their qualified business income (QBI), subject to limitations based on taxable income and type of business (SSTB v. non-SSTB). But, not all eligible filers are taking advantage of this tax break. In fact, treasury inspectors identified nearly 900,000 returns filed for 2018 in which filers appeared to qualify for the deduction, but did *not* take it for one reason or another. As a result, the IRS "intends to increase its outreach to preparers and taxpayers on this deduction."

The **TCJA** only mentioned employees as *not* being engaged in a "qualified trade or business" along with SSTBs where the taxpayer's taxable income, *before* any Sec. 199A deduction, is above the *end* of the phaseout range (i.e., $163,300, or $326,600 for MFJ filers in 2020). There is no mention of any specific restriction as to "rental income" in the **TCJA Conference Agreement** (Cf. **Page 30** of the 1097-page **TCJA Conference Agreement** as to what businesses are *not* "qualified trades or businesses" for purposes of the Sec. 199A deduction, as well as **Code §199A(d)**) when Congress chose to include this income at the last minute for Sec. 199A purposes. Yet, the reg writers persist that a "Sec. 162 T/B standard" must be met in order for net rental income (or, loss) to be counted as QBI (or, QBL).

There are three distinct ways in which the reg writers state this "Sec. 162 T/B standard" can be satisfied. They are as follows:

1. The IRS "safe harbor" of 250 hours annually is met (i.e., **Rev. Proc. 2019-38**);

2. The rental is to a commonly controlled flowthrough entity (i.e., *not* a C corporation); or

3. Under a "facts-and-circumstances test," the rental activity is conducted on a "regular and continuous" basis and is entered into for a "profit motive." (Cf. ***Commr. v. Groetzinger*, 480 U.S. 23, (S Ct, 2/24/1987)** which addressed whether a gambler was eligible to take his losses on **Schedule C** as a "trade or business of gambling" v. as a miscellaneous itemized deduction)

Even though the rental of property does *not*, as a matter of law, constitute a trade or business, and is therefore *not* subject to the imposition of self-employment tax, under appropriate circumstances, the longstanding definition of "trade or business" can in fact involve the rental of even *one* property (Cf. ***Curphey v. Commr.*****, 73 TC 766, (1980)**).

The **JCT Explanation of the TCJA** (i.e., the **"Blue Book"**) stated that if the rental is treated as a "trade or business under relevant sections of the Code" (Cf. **Code §162; 163(j); 179; 469; 1231**, even if it is *not* treated as such for S/E tax purposes under **Code §1402**), it would be a T/B for purposes of **Code §199A**.

So, focusing in on the "regular and continuous" and "profit motive" tests, consider the following examples:

> **Example - "Real Estate Professionals:"** Although rents counting as QBI is *not* dependent on whether you are "materially participating" under the passive loss rules, these "real estate professionals" are putting in at least 750/year (without counting any time by their employees or independent contractors). And, they are most assuredly trying to achieve a positive cash flow in the interim, let alone long-term underlying appreciation in their property holdings. As a result, this would be one of the "easiest" situations where the rentals (income or loss) should be classified as "qualified trades or businesses" for purposes of the Sec. 199A deduction.
>
> **Example - "Commonly-Controlled Tenants/Lessees:"** Likewise, the reg writers took away all indecision when they stated that if the landlord/lessor controlled 50% or more of the tenant/lessee, these rental activities would also *automatically* meet the "Sec. 162 T/B standard" for purposes of the Sec. 199A deduction. For instance, A and B own an S corp (or, partnership) accounting firm while also owning the building in an LLC where this business is the *sole* tenant (even though it is a SSTB, it is still treated as a "Sec. 162 T/B"). Whether the net rental income qualifies for the Sec. 199A deduction will depend on the level of taxable income A and B have on their personal tax returns, *before* considering any Sec. 199A deduction.
>
> **Example - "Multiple Rentals, But Not REP:"** Here, you might have a busy professional (e.g., doctor, lawyer, CPA, etc.) owning multiple rental properties where they do *not* "control" the tenant/lessee, and fail to put in at least 250 hours annually (even when considering outside help such as a property management company or employees, or independent contractors such as plumbers, electricians, carpenters, or landscapers). It will instead be a matter of "facts-and-circumstances" which decides whether the "Sec. 162 T/B standard" is met. But, have they been involved on a "regular and continuous" basis overseeing (even for out-of-state rentals as a "principal" guiding their "agent") day-to-day decisions regarding maintenance and repairs, tenant/lessee approval, and all other important matters? And, do they aim to have a long-term "profit motive" when considering the underlying appreciation potential of the various properties (even disposing of those rentals whose upside potential is going nowhere)?
>
> **Example - "Single-Property Rental Landlords:"** Some practitioners shy away from situations where maybe only a few properties are involved and the landlord is *not* involved (e.g., out-of-state rentals where local property management companies handle all of the day-to-day matters). And, this might be a tougher case in arguing for the "Sec. 162 T/B standard" being met. But, take the example of a couple living in half of their duplex property while renting the other half. And, it is the only rental property that they own. Here, the retired husband spends 2 to 3 hours each week (but, less than 5 hours/week needed for the "safe harbor") cutting grass or clearing snow, while doing all of the routine maintenance and repairs on a day-to-day basis. The wife advertises the property for rent when needed, interviews prospective tenants, and handles all of the finances. The property has been consistently rented for over 20 years resulting in a positive cash flow each month, while also having over $200,000 of appreciation on the rental portion. Arguably, there is a "regular and continuous" involvement by these landlords, and certainly they have achieved a

"profit" over the period of holding the property as a rental. Therefore, the rental income should be treated as QBI even though they only own this *one* rental property.

Example - "Triple Net Leases:" This is one area where the IRS continues to insist that the involvement of the lessor/landlord is so minimal that it basically amounts to just collecting a rental check each month and depositing it into a bank account. Nevertheless, so many of our clients own, for example, a rental property in an LLC and lease it to their controlled business entity as the sole tenant. Given these facts, the reg writers have stated unequivocally that the "Sec. 162 T/B standard" is satisfied. And, even where the tenant/lessee is *not* controlled by the landlord/lessor, have the responsibility for the interest and taxes shifted back onto the shoulders of these property owners. Then, the question is whether a "TNL" is still involved (i.e., where only the maintenance and repairs for the property is the responsibility of the tenant) which means the question of QBI for the rents will be based on the "facts-and-circumstances" test.

Example - "Sporadic Rentals Such as AirBnB or VRBO:" This is most certainly the "weakest" of all rental scenarios where the property in question is only rented out when the owners are *not* using it personally and on a very sporadic basis. In other words, it would be hard to argue that the landlord's involvement was "regular and continuous." Moreover, the owner is simply looking for some additional cash flow to offset a portion of the annual interest, taxes and maintenance expenses, resulting in a net rental loss in most years (and, one that cannot be currently claimed if the owner's personal use exceeded 14 days or was treated as a passive loss). But, you would probably *not* want the rental to be treated as a "qualified trade or business" if the likely losses would just serve to reduce other positive sources of QBI.

Comment: Obviously, if the rental is for less than 15 days annually, any net rental income is ignored and the home is just treated as a personal residence (e.g., the DNC is coming to Milwaukee and homes near downtown can rent for up to $10,000 for the week in question, or the homes in Augusta, GA rented each year for two weeks while the Masters golf tournament is going on). **(Code §199A; Sec. 199A Deduction)**

☞**Additional Final Regs Issued on Sec. 199A Deduction and Suspended Loss Rules (T.D. 9899)**

The IRS has released "additional final regulations" on the Sec. 199A qualified business income (QBI) deduction under **Code §199A**. This additional guidance allows a shareholder in a Regulated Investment Company (RIC) (i.e., as defined in **Code §851(a)**) to take a QBI deduction with respect to certain income of, or distributions from, the RIC. Furthermore, the regulations provide guidance on (1) the treatment of previously disallowed losses that are included in QBI in subsequent years and (2) interests held in split-interest or charitable remainder trusts. The final regs apply to tax years beginning *after* 8/24/20. However, taxpayers may elect to apply the regs to tax years beginning *on or before* 8/24/20. Alternatively, taxpayers who chose to rely on regulations initially proposed in February 2019 (**REG-134652-18**) for tax years beginning *on or before* 8/24/20 may continue to do so for such years. **(Code §199A; Sec. 199A Deduction)**

Comment: A more common situation is where you have losses or deductions (e.g., K-1 losses or Sec. 179 immediate expensing) suspended due to a number of reasons such as the lack of basis, or at-risk basis, or the passive loss rules. In such instances it is critical to separate and keep track of pre-2018 v. post-2017 amounts since when the *former* items eventually free up they do *not* reduce "qualified business income" for purposes of the Sec. 199A deduction. The reason is that when they first came into existence (i.e., in a pre-2018 tax year), **Code §199A** was *not* even yet in the law. So, even if the tax benefit of these amounts is first realized in a post-2017 tax year, they will *not* serve to reduce any QBI otherwise eligible for the 20% Sec. 199A deduction.

☞**Impact of Passthrough Losses or Deductions on QBI**

The final Sec. 199A regs clarify that if a K-1 loss (**Box 1** T/B or **Box 2** rental) is suspended due to the basis, at-risk or PAL rules, it will *not* have a current impact on the calculation of "qualified business income" (QBI). Arguably, this would also be the approach as to other losses or deductions which currently yield no tax benefit. For example, if a flowthrough entity were to make a charitable contribution with an allocable portion thereof being passed through as a separately-stated item on a K-1, but that partner/S corp shareholder is taking the standard deduction on their personal return, then no tax benefit is received (and, there is no carryover of the charitable deduction to a future tax year). As a result, QBI is *not* affected by this forgone deduction. Furthermore, this would be true of other losses and deductions for which the taxpayer is receiving no current tax benefit. But, for instance, when a suspended passive loss on **Form 8582** finally frees up (e.g., because of the "disposition rule"), then it will indeed be considered in the calculation of a taxpayer's QBI for purposes of Sec. 199A. **(Code §199A; QBI)**

> **Comment:** Although somewhat rare, if either QBI or QBL from an SSTB occurs in the year where a taxpayer's taxable income, before any Sec. 199A deduction, is above the end of the applicable phaseout range, neither amount should be carried over to the following tax year. And, though unfair, the same is true of QBI from a non-SSTB where the taxpayer's taxable income, before any Sec. 199A deduction, is above the applicable "threshold" but they fail to have sufficient support (i.e., either wages or UBIA) to take the Sec. 199A deduction. But, on the other hand, if the taxpayer has a net QBL from a non-SSTB (i.e., it is *not* fully absorbed in the calculation of the current year's net QBI), then is needs to be carried over to the following tax year and used to determined overall QBI, if any. This is also true of a net QBL from a SSTB where the taxpayer's taxable income, before any Sec. 199A deduction, is *not* above the end of the otherwise applicable phaseout range (i.e., $50,000 or $100,000 beyond the end of the applicable 24% marginal tax bracket).

☞**Sec. 469 Grouping Elections v. Sec. 199A Aggregation Elections**

Although both elections can be beneficial to an individual's overall tax situation, it is imperative that one clearly understands the differences between these two distinct elections, and how and when to make them.

> **Note: There has been some consideration by Congress to do away with the Sec. 199A deduction, at least for higher-income taxpayers (i.e., those with taxable income exceeding $400,000).**

Code §469 Passive Loss Grouping Elections: There are three separate and distinct situations where a "grouping election" might make sense. They are as follows:

- **"Real Estate Professionals:"** If an individual qualifies as a "real estate professional" either by occupation (e.g., real estate brokerage, construction, or development), or by the multitude of real activities owned (i.e., they "eat, sleep and breathe real estate" and have no other significant non-real estate trades or businesses), they still have to "materially participate" in their rental activities (i.e., under any one of the seven distinct "tests" listed in **Reg. §1.469-5T**). But, this might be virtually impossible when the REP owns so many rental properties that they could *not* meet any of these "material participant standards" in each and every one. As a result, on an "all-or-nothing basis," an election might have to be made to group all of the taxpayer's various rental activities as just "one rental activity." This is done on each rental property owner's personal return (even if a particular rental activity is owned/titled in an LLC's name). So, each LLC member can decide if a "grouping election" is beneficial and something that they want to do on an individual Form 1040 basis. But, once made, the "grouping election" does *not* have be made again, unless additional rental activities are acquired by the taxpayer and they choose to add these additional rentals to the original grouping election.

Comment: Most practitioners continue to include the “grouping election” statement when filing subsequent tax returns as a reminder that, in fact, such an election has already been made. But, it is *not* mandatory.

The election is binding for the tax year in which it is made and for *all* future years in which the taxpayer is a qualifying “rental real estate professional,” even if there are intervening years in which the taxpayer is *not* a qualifying taxpayer. But, in years in which the taxpayer is *not* a qualifying taxpayer, the rental real estate activities will be treated as passive activities. The taxpayer may revoke the election if there is a “material change in the taxpayer’s facts and circumstances.” To revoke the election, the taxpayer needs to file a statement with the taxpayer’s original income tax return for the tax year in question. The statement must contain a declaration that the taxpayer is revoking the election under **Sec. 469(c)(7)(A)** and an explanation of the nature of the “material change.”

If a taxpayer qualifies as a “real estate professional” and makes the election to treat *all* of their interests in *rental real estate* as a single rental real estate activity, the taxpayer may *not* group a “rental real estate activity” with any other activity, even if the other activity is in a “real property trade or business.” For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer may *not* group the interest in rental real estate with their development activity or construction activity if they makes the election.

Example: “Grouping to Satisfy Material Participation Test”
A taxpayer owns 150 separate rental real estate activities (both residential and commercial). They generate an overall $1 million net rental income profit each year. Not wanting to pay the 3.8% Medicare surtax (i.e., $38,000 on **Form 8960**), he decides to group *all* of these rental activities as *one* single activity for purposes of the passive loss rules and to establish that he is “materially participating” in them as a REP.

Example: “Need as Passive Income Generator (PIG)”
A taxpayer owns 20 rental properties which generate about $100,000 each year in net rental income. He is retired and has no other W-2 or self-employment income. Even though he averages 15 hours or more each week (i.e., > 750 hours annually), he decides against making a grouping election for purposes of proving “material participation” in his rental activities as a whole. Instead, he wishes to preserve this rental income as passive since he typically has $100,000 or more of passive losses each year from various other business investments. And, he would face no NIIT on **Form 8960** since the passive losses offset the passive rental income each year.

Grouping Multiple Businesses as an “Appropriate Economic Unit: **Regs. §1.469-4** sets forth the rules for grouping a taxpayer’s trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of Sec. 469. A taxpayer may treat one or more trade or business activities or rental activities as a *single* activity if the activities constitute an “appropriate economic unit.” In determining “appropriate economic units,” factors to be considered are similarities and differences in types of trades or businesses, the extent of common control, the extent of common ownership, geographical location, and interdependence between or among the activities.

Example: “Ownership of Multiple Common T/Bs”
A taxpayer owns 100% of five S corporations which each owns a separate Subway sandwich shop in the NYC area, along with separate S corp owning a sporting goods store in Denver, CO. As far as the Subway businesses, he uses a centralized payroll/human resource department, and purchases all of his supplies and foodstuffs for each Subway store from the same vendors to secure a bulk discount. He then decides to open a new Subway location which will probably have a loss for at least the first year (from taking 100% bonus depreciation on new equipment

purchases, as well as leasehold improvements). Not wanting to have any question regarding this loss being passive (though he will devout a great deal of his time to this new location), he elects to treat all six Subway businesses as *one* activity for purposes of the passive loss rules since they arguably comprise an "appropriate economic unit." Under these circumstances, it would appear that this is a valid "grouping election." Nevertheless, given the diverse nature of his sporting goods business located in Denver, it would *not* be an appropriate candidate to be included in this election.

Grouping Rental Activities with T/Bs: Generally speaking, a taxpayer is *not* permitted to group a rental activity with a trade or business activity unless the activities being grouped together constitute an "appropriate economic unit" *and* are "insubstantial in relation to each other." For example, a taxpayer may *not* group a rental activity with a trade or business activity unless the rental activity is "de minimis" in relation to the trade or business activity. Conversely, a taxpayer may *not* group a trade or business activity with a rental activity unless the trade or business activity is "de minimis" in relation to the rental activity. In addition to this "insubstantial test," a grouping election may be made where there is "identical ownership" between the trade or business and the separate rental activity.

Comment: For a discussion as to what might be a possible threshold for this "de minimis" test, read over one of the few Court decisions on this issue to-date in ***Candeleria*, 518 F. Supp. 2d 852 (W.D. Tex. 2007)** where the gross rents received by the rental activity were less than 20% of the overall business gross receipts of the business tenant paying those rents.

Comment: This "de minimis" test is useful where "identical ownership" does *not* exist, for instance, between the business tenant and the LLC owning the real property.

Example: "Rentals Where Identical Ownership Not Present"
A and B owned a business which leases a building owned by an LLC with A and B, along with C an outside investor, being the three owners. Lacking identical ownership between the two activities, but anticipating a rental loss for the current year, they might consider the "de minimis" test instead to justify the election to group them.

Example: "Grouping Where Cost Seg Study Results in Rental Loss"
After a cost segregation study, the taxpayer decides to file **Form 3115** to "catch up" on a significant amount of missed depreciation (i.e., due to the misclassification of various assets as real estate). In turn, this will result in a large "negative adjustment" (i.e., under **Code §481**) which according to **Rev. Proc. 2002-19** must be reported on their current-year return. The SMLLC holding the property is also owned by the *same* taxpayer whose business is the sole tenant, but this write-off will cause a large rental loss (despite that fact that the normal amount of rent was paid again this year). With a "grouping election" (which is allowed due to the *identical ownership* between the tenant/business and the landlord/LLC owned by *same* taxpayer and in the *same* proportions), this "self-rental loss" will be treated as *nonpassive*.

Comment: If a grouping election could *not* be made (for instance, because "identical ownership" did *not* exist between the landlord and their tenant business, or the "de minimis test" *was* not met), then the resulting rental loss would, in fact, treated as *passive*. Nevertheless, should the rental schedule go back to having net income the following year, this "self-rental income" would still *not* be considered passive, but it could first be used to offset the rental loss from the prior year (with any *excess rental income* being treated as *nonpassive*). In other words, under the "recharacterization regs," self-rental income is *not* treated as *nonpassive* until (if needed) it offsets any suspended rental losses from that *specific rental activity first*.

Late Grouping Elections: On May 31, 2011, the IRS issued **Rev. Proc. 2011-34**, which provides special procedures for relief for *late* **Regs. §1.469-9(g)** elections. The revenue procedure gives taxpayers the ability to obtain relief for a late election without the necessity of first obtaining a private letter ruling. And, under this revenue procedure, the user fees normally associated with private letter rulings do *not* apply to those seeking relief for a late election.

A taxpayer is eligible for an extension of time to file a **Reg. §1.469-9(g)** election if the taxpayer represents in a statement that they meets *all* of the following requirements:

- The taxpayer failed to make an election under **Reg. §1.469-9(g)** solely because they failed to timely meet the requirements in **Reg. §1.469-9(g)**;

- The taxpayer filed *consistently* with having made an election under **Reg. §1.469-9(g)** on any return that would have been affected if they had in fact timely made the election;

- The taxpayer *timely filed* each return that would have been affected by the election if it had been timely made; and

- The taxpayer has "reasonable cause" for their failure to meet the requirements in **Reg. §1.469-9(g)**.

The taxpayer is required to attach the statement required by **Reg. §1.469-9(g)(3)** to an amended return for the most recent tax year and mail the amended return to the IRS Service Center where they will file the current-year tax return. The statement must contain the declaration required by **Reg. §1.469-9(g)(3)**, an explanation of the reason for the failure to file a timely election, and a declaration of the four requirements mentioned above being satisfied. The statement must identify the tax year for which the taxpayer seeks to make the late election. Finally, the statement must state at the top of the document **"Filed Pursuant to Rev. Proc. 2011-34."**

"Aggregation Elections" under Sec. 199A: As stated in the final regs, the aggregation rules provided in **Reg. §1.199A-4** "are optional and are intended to assist taxpayers in applying the W-2 wage and UBIA of qualified property limitations in situations in which a unified business is conducted across multiple entities."

> **Comment:** Both the Treasury Department and the IRS specifically stated in the final regs that they do *not* consider the "grouping rules" under **Code §469** an appropriate method for determining whether a taxpayer can aggregate trades or businesses for purposes of applying section 199A.

- General Sec. 199A Aggregation Requirements: These "aggregation election" rules are applied at the trade or business level and include:

1) Rules that allow a taxpayer to aggregate trades or businesses based on a "50-percent ownership test," which must be maintained for a *majority* of the taxable year and that majority of the taxable year must include the *last* day of the taxable year.

2) The "ownership rule" in the regs does *not* require that *every* person involved in the ownership determination own an interest in *every* trade or business. Instead, this rule is satisfied so long as one person (or, group of persons) holds a > 50% ownership interest (i.e., directly or by attribution through **Code §§267(b)** or **707(b)**),in each trade or business. But, the regs go on to state that trades or businesses to be aggregated must meet *all* of the requirements of **Reg. §1.199A-4**, *not* just this "ownership requirement."

3) All items attributable to aggregated trades or businesses must be reported on returns for the *same* taxable year (and, this is now required on **Form 8995** or **Form 8995A**).

4) SSTBs cannot be aggregated with other SSTBs. Nor, can a SSTB be aggregated with a non-SSTB.

Comment: Keep in mind that if a particular taxpayer's taxable income, before any Sec. 199A deduction, is below the applicable threshold, then the SSTB "label" is disregarded. More importantly, there would be no need for support of the Sec. 199A deduction with the use of "wages" or UBIA.

Example: "Rental Income Recharacterized as Additional SSTB Income"
A and B owned a SSTB, while also owning the LLC which leases the building to the SSTB which is the *sole* tenant. Any net rental income will be "tainted" (i.e., recharacterized) as *additional* SSTB income (even though the underlying rental activity is *not* itself treated as a SSTB). Nevertheless, under the statement contained in the final regs, the two activities could *not* be combined in an "aggregation election" (i.e., since the business is a SSTB).

Comment: An aggregation election is useful where the potential Sec. 199A deduction with regard to the net rental income cannot be fully supported by only any UBIA (given that "wages" tend *not* to be prevalent on most rental schedules). Instead, with a proper aggregation election, the rental schedule can "look to" the wages (and, possibly, UBIA) of the related business to support a Sec. 199A deduction with regard to the rental income (assuming that the taxpayer's taxable income, before any Sec. 199A deduction, is *above* the applicable "threshold").

Comment: But, what if the SSTB owned by A&B only occupies, for example, 10% of the square footage of the rental property and the remaining of the space is leased to unrelated third-parties? Can the aggregation election now be made? It seems that you would still be seeking to aggregate a non-SSTB (i.e., the rental activity) with a SSTB and, therefore, the regs would *not* permit it (also, you arguably would *not* meet the "two-out-of-three-factor test" required for an aggregation election). The only "counter argument" would be if the SSTB portion of the business in question was "de minimis" (i.e., < 10%) then it could be ignored and, thus, you would be aggregating two non-SSTB activities.

5) To determine whether trades or businesses may be aggregated, the regs provide that multiple trades or businesses must, among other requirements, satisfy *two of three listed factors*, which demonstrate that the businesses "are part of a larger, integrated trade or business." These factors include:

(a) The businesses provide products and services that are the same (e.g., a restaurant and a food truck) or customarily provided together (e.g., a gas station and a car wash);

(b) The businesses share facilities or share "significant centralized business elements" (e.g., common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); or

(c) The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (e.g., supply chain interdependencies).

Comment: Both the Treasury Department and the IRS declined to define "significant" in terms of "centralized business elements" in the *second* factor above because "the answer is dependent on the facts and circumstances of each combination of trades and businesses." And, they rejected the suggestion of possibly reducing the required number of factors since it "would allow the aggregation of trades or businesses that are *not* owned and operated as integrated businesses."

Comment: The final regs reiterate that "aggregation is optional and the inability to aggregate does *not* preclude a taxpayer with QBI from multiple trades or businesses from claiming a Sec. 199A deduction on the separate trades or businesses to the extent otherwise allowed by Sec. 199A and these regulations."

Aggregation by RPEs: The final regs permit a "relevant passthrough entity" (RPE) (i.e., partnership or S corporation) to aggregate trades or businesses it operates directly or through lower-tier RPEs. But, the resulting aggregation must be reported by the RPE *and by all owners of the RPE*.

Comment: Even though the actual *aggregation election* is made at the RPE level, these aggregated activities would now be reported on *both* the RPE's tax return, as well as on either **Form 8995** or **Form 8995A**.

Reporting and Disclosure: The regs require "consistent reporting" of aggregated trades or businesses. As mentioned previously, each individual who chooses to aggregate must attach a statement to their return *annually* (i.e., on either **Form 8995** or **Form 8995A**) identifying each trade or business to be aggregated.

Initial Aggregation Election: The final regs provide that a taxpayer's failure to aggregate trades or businesses "will *not* be considered to be an 'aggregation election' under this rule." As a result, a later aggregation election would *not* be precluded in a future year's tax return (or, adding to a taxpayer's *previous* aggregation election where appropriate such as the acquisition of an additional trade or business that qualified). But, the regs go on to state that generally disallow for an initial aggregation to be made on an *amended* return "as this would allow aggregation decisions to be made with the benefit of hindsight." Finally, a taxpayer who chooses to aggregate must continue to aggregate each taxable year "unless there is a material change in circumstances that would cause a change to the aggregation."

Comment: The one exception as to using an amended return to make an *initial* aggregation election would be for the 2018 tax year since the regs state that there "may have been some confusion" with regard to this first year that the Sec. 199A was otherwise available.

Failure to Include Aggregation Election with Return: The regs permit the IRS to "disaggregate trades or businesses" if a taxpayer fails to attach the required *annual* disclosure (i.e., even if they did include the initial aggregation election with the first tax year in which it was to be effective).

Comment: This is why it is so important to distinguish between a "grouping election" for the passive loss rules (where an "annual disclosure" is *not* required) v. an "aggregation election" where it is mandatory.

Is an "Aggregation Election" Always Beneficial: Consider the following example:

	T/B #1	T/B #2	No Aggregation	With Aggregation
QBI	100,000	100,000	-	200,000
Wages	8,000	-	-	8,000
UBIA	-	200,000	-	200,000
20% QBI	20,000	20,000		40,000
50% Wages	4,000	-	-	4,000
25% Wages	2,000	-	-	2,000

2.5% UBIA	-	5,000	-	5,000
Greater:	4,000	5,000		7,000
Sec. 199A Deduction	4,000	5,000	**9,000**	**7,000**

Comment: If the taxpayer in this example had taxable income (before any Sec. 199A deduction) of less than the end of their applicable 24% marginal tax bracket, there would be no need to "support" the initial Sec. 199A deduction with either wages or UBIA. This "need" only arises once that taxable income level exceed the end of the 24% marginal tax bracket and enters the phaseout ranges (i.e., of either $50,000 or $100,000), and beyond.

Comment: You can add zeros if you want, but given these comparable figures, an "aggregation election" would *not* benefit the taxpayer in this instance. **(Code §§199A & 469; Sec. 199A Deduction)**

☞SSTBs with Carryover Losses

The final regs (Cf. **page 75** at the top) clearly state that "for taxpayers with taxable income (before the Sec. 199A deduction is taken into account) above the end of the applicable phase-in range, an SSTB is *not* a qualified trade or business." So, for those taxpayers with net income or loss from a SSTB, and whose taxable income before any Sec. 199A deduction is above the end of the phaseout range (i.e., $50,000, or $100,000 for MFJ filers, and above the end of the 24% tax bracket; $163,301, or $326,600 for MFJ filers for 2020), neither net income or net losses in 2020 should have to be carried over to the 2021 tax year (i.e., as shown on **Line 3** of **Form 8995** or **Schedule C** of **Form 8995A**).

Comment: Clearly QBI from 2020 for which a potential Sec. 199A deduction (i.e., "QBI component") was *not* fully (or, partially within the phaseout range) supported (i.e., with either "wages" or UBIA) cannot be carried over to a future tax year. But, on the other hand, any "qualified business loss" (QBL) from a non-SSTB must generally be carried over. On the other hand, though it might occurred infrequently, QBLs from a SSTB are, by definition, *not* from a "qualified trade or business" if the taxpayer's taxable income, before any Sec. 199A deduction, is *above the end* of the applicable phaseout range. Even the proposed regs state that unless a taxpayer's taxable income, before any Sec. 199A deduction, was below the end of the phaseout range, if a trade or business is an SSTB, then "none of its items are to be taken into account for purposes of determining a taxpayer's QBI."

Example: "Carryover of Excess SSTB Losses"
Ron graduates from dental school and decides to open his own practice with the accompanying cost of approximately $500,000 for new equipment for which he elects 100% bonus depreciation resulting in a QBL for this SSTB. He is, however, married to a successful litigation attorney whose income results in them having over $415,000 of taxable income, before any Sec. 199A deduction, on their 2019 joint return. Based on the language in the final regs, this loss from the first year of Ron's dental practice would *not* have to be carried over to the succeeding tax year (i.e., since it is *not* considered to be from "qualified trade or business").

Comment: An activity will be considered a SSTB regardless of whether the owner is "materially participating" or passive under the **Code §469** rules.

☞IRS Releases FAQS on the Sec. 199A Deduction for Qualified Business Income

- In a **frequently asked question** (FAQ) format, the IRS has issued what it describes as "basic guidance" on the Sec. 199A pass-through deduction, which was enacted in the **Tax Cuts and Jobs Act**.

Comment: The IRS stated that it will be issuing separate guidance for co-ops.

- The IRS explains that under **Code §199A**, eligible taxpayers may be entitled to a deduction of up to 20% of "qualified business income" (QBI) from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust or estate. **For taxpayers with taxable income that exceeds $329,850 for a married couple filing a joint return, or $164,925 for all other taxpayers (i.e., end of 24% marginal tax bracket for 2021 returns), the deduction is subject to limitations which are based on the type of trade or business, the taxpayer's taxable income, the amount of W-2 wages paid by the qualified trade or business and the "unadjusted basis immediately after acquisition" (UBIA) of qualified property held by the trade or business.** Income earned through a C corporation or by providing services as an employee is *not* eligible for the deduction.

- **Eligible taxpayers may also be entitled to a deduction of up to 20% of their "combined qualified real estate investment trust (REIT) dividends" and "qualified publicly traded partnership (PTP) income." This component of the Code Sec. 199A deduction is *not* limited by W-2 wages or the UBIA of qualified property.** The sum of these amounts and the above amount based on QBI is referred to as the "combined qualified business income amount." Generally, the deduction is the *lesser* of the "combined qualified business income amount" or an amount equal to 20% of the taxable income minus the taxpayer's net capital gain.

- **The deduction is available for tax years beginning *after* Dec. 31, 2017, regardless of whether an individual itemizes their deductions or takes the standard deduction on Form 1040.** (**FAQ No. 1**)

- Individuals, trusts and estates with QBI, qualified REIT dividends, or qualified PTP income may qualify for the deduction. But, in some cases, patrons of horticultural or agricultural cooperatives may be required to reduce their deduction. (**FAQ No. 2**)

- S corporations and partnerships are generally *not* taxpayers and cannot take the deduction themselves. However, **all S corporations and partnerships report each shareholder's or partner's share of QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends and qualified PTP income on Schedule K-1, so the shareholders or partners may determine their deduction.** (**FAQ No. 3**)

Comment: **For 2018, all of this information was "coded" and broken out in Box 20 of the K-1. But, for 2019 onward, a simple "Code Z" is used for information related to the Sec. 199A deduction passing through on the K-1.**

- Determining the deduction: In the FAQs, the IRS explains how to compute the QBI deduction. It also provides a number of definitions needed to understand the computation.

- Qualified business income (QBI): QBI is the net amount of qualified items of income, gain, deduction and loss from any "qualified trade or business." **Only items included in taxable income are counted (i.e., so the basis, at-risk and PAL limitations have to be applied first). In addition, the items must be "effectively connected with a U.S. trade or business." Items such as capital gains and losses, certain dividends and interest income are excluded**. (**FAQ**

No. 4)

- Qualified trade or business: A "qualified trade or business" is any trade or business, with two exceptions:

1. "Specified service trade or business" (SSTB), which includes a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, dealing in certain assets **or any trade or business where the principal asset is the reputation or skill of one or more of its employees.**

Comment: This exception only comes into play if a taxpayer's taxable income (before considering the Sec. 199A deduction) exceeds the end of the applicable 24% marginal tax bracket.

2. Performing services as an employee.

- Computation: The SSTB limitation does *not* apply if a taxpayer's taxable income (before the Sec. 199A deduction) is below the end of the applicable 24% marginal tax bracket.

The deduction is the *lesser* of:

A. 20% of the taxpayer's QBI, plus 20% of the taxpayer's qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, or

B. 20% of the taxpayer's taxable income minus "net capital gains" (i.e., any source of income that is taxed at a special tax rate such as LTCGs, qualified dividends, unrecaptured Sec. 1250 gain, etc.).

- **If the taxpayer's taxable income is above the end of the taxpayer's applicable 24% marginal tax bracket, the deduction may be limited based on whether the business is an SSTB, the W-2 wages paid by the business and the unadjusted basis (UBIA) of certain property used by the business.** These limitations are phased in for joint filers with taxable income between $329,850 and $429,850, and all other taxpayers with taxable income between $164,925 and $214,925. These threshold amounts and phase-in range are for tax year 2021 and will be adjusted for inflation in subsequent years. (**FAQ No. 6**)

Examples: In addition, in the FAQs, IRS answers several questions dealing with specific scenarios.

Example 1: A taxpayer who has income from an SSTB asks how this affects his deduction. **The IRS stated that the SSTB limitation does *not* apply to any taxpayer whose taxable income is *below* the end of the applicable 24% marginal tax bracket.** For taxpayers whose taxable income is within the phase-in range, the taxpayer's share of QBI, W-2 wages and UBIA of qualified property related to the SSTB may be limited. If the taxpayer's taxable income exceeds the phase-in range, no deduction is allowed with respect to any SSTB. (**FAQ No. 7**)

Example 2: "Taxable Income Below End of Applicable 24% Marginal Tax Bracket"
A taxpayer with taxable income (before any Sec. 199A deduction) is under the end of their 24% marginal tax bracket asks if he has to determine if he is in an SSTB to take the deduction? The IRS stated that the answer is no, if the taxpayer's taxable income (before

the Sec. 199A deduction) is below this applicable threshold. In other words, it does *not* matter what type of business the taxpayer is in. The taxpayer will be able to deduct the *lesser* of:

a. 20% of his QBI, plus 20% of his qualified REIT dividends and qualified PTP income, or

b. 20% of his taxable income minus his net capital gains. (**FAQ No. 8**)

Example 3: "Taxable Income in Applicable Phaseout Range"
A taxpayer with taxable income within the phaseout range and filing as single who receives QBI asks if it matters if it is from an SSTB. The IRS stated yes and because his taxable income is above the threshold amount, his Code Sec. 199A deduction with respect to any SSTB will be limited. However, because he is within the phase-in range, he may be allowed some Code Sec. 199A deduction with respect to an SSTB. In addition, for taxpayers above the threshold amount, the Code Sec. 199A deduction with respect to any trade or business, including an SSTB, may be limited by the amount of W-2 wages paid by the trade or business and the UBIA of qualified property held by the trade or business. (**FAQ No. 9**)

Example 4: "Taxable Income Above End of Phaseout Range - SSTB"
A taxpayer with taxable income above the end of the phaseout range and filing as single whose only income is from an SSTB asks if he is entitled to the deduction with respect to the SSTB. **The IRS stated no and the same is true for a married couple filing a joint return whose taxable income exceeds the end of their applicable phaseout range.** However, the IRS notes that he may be entitled to a deduction for QBI earned from another trade or business that is *not* an SSTB or from qualified REIT dividends or qualified PTP income. (**FAQ No. 10**)

Example 5: "Taxable Income Above End of Phaseout Range - Non-SSTB"
A taxpayer with taxable income above the end of the phaseout range and filing as single who is *not* engaged in an SSTB asks if he is entitled to the deduction. **The IRS stated yes, given he has QBI, qualified REIT dividends or qualified PTP income**. However, the deduction for QBI may be limited by the amount of W-2 wages paid by the qualified trade or business and the UBIA of qualified property held by the trade or business. (**FAQ No. 11**)

☞**IRS Adds & Updates FAQs on Sec. 199A Deduction (Rev. 03/01/2021)**
The IRS has added and updated answers to frequently asked questions about the **Code §199A** qualified business income deduction (i.e., QBID or pass-through deduction).

Background: Under **Code §199A**, an individual with a "qualified trade or business" (QTB) who operates that QTB as a sole proprietorship, partnership, or S corporation is permitted to deduct up to 20% of their "qualified business income" (QBI). QBI includes "qualified items" of income, gain, deduction and loss from a trade or business that is effectively connected with the conduct of a trade or business in the U.S. This includes qualified items from partnerships (other than publicly traded partnerships (PTPs)), S corporations, sole proprietorships, and certain estates and trusts, "that are allowed in calculating the taxpayer's taxable income for the year" (i.e., if the at-risk basis, passive loss, **Code §461(l)** excess business or capital loss rules apply, then the potential QBI item is suspended until such time as it can be used in calculating one's tax).

Generally, a "specified service trade or business" (SSTB) is *not* a QTB (but, the Sec. 199A deduction would still apply if the taxpayer's modified AGI is below the "applicable threshold" which is the end of the 24% marginal tax bracket). An SSTB is any trade or business providing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, partnership interests, commodities, or any trade or business "where the principal asset is the reputation or skill of one or more of its employees or owners."

> **Comment:** Surprisingly, this last SSTB "field" does *not* include teaching or consulting, or writing tax newsletters or other explanatory guides.

> **QBID FAQs Added or Updated:** The IRS has added or updated the following QBID FAQs:

Q6: What if a *single* trade or business has *multiple* sources of income, some from specified service activities (SSTB) and some from other activities?

A6: There is a "de minimis rule" for a single trade or business that has income from both specified service activities and other activities. Under the de minimis rule, if a trade or business has gross receipts of $25 million or less and less than 10% of its gross receipts are attributable to specified service activities, or gross receipts of more than $25 million and less than 5% of its gross receipts are attributable to specified service activities, the trade or business as a whole is *not* an SSTB. However, if the gross receipts from specified service activities exceed the percentage specified above, the *entire* trade or business is treated as an SSTB.

> **Comment:** Where does the IRS get the authority to make this kind of conclusion? For instance, if an eye doctor operates their business as an S corporation, and clearly keeps the books and records to segregate the gross receipts from rending professional services (e.g., providing eye exams, performing surgeries, etc.) as opposed to fitting and selling eye glasses and contact lenses, arguably the understanding has been that this S corporation has a combination of both SSTB income along with non-SSTB gross receipts. The same would hold true for an audiologist who provides hearing tests, but also sells hearing aids.

Q9: What are the "W-2 wages" for purposes of applying the W-2 wage limitation? Do W-2 wages paid to the officer of an S corporation qualify as QBI and towards the W-2 wage limitation?

A9: For purposes of the W-2 wage limitation, W-2 wages include:

1. The total amount of wages paid to employees; and

2. Certain deferred compensation.

Both wages and deferred compensation must be reported to the Social Security Administration on a timely-filed return. Additionally, the W-2 wages must be "properly allocable to QBI." W-2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI for the trade or business. W-2 wages paid to an S corporation officer will generally *not* qualify as a source of QBI to the employee. However, such wages will generally be included in the employer's QBI. Additionally, W-2 wages paid to an S corporation officer that are:

1. Properly allocable to QBI, and

2. Are reported to the SSA on a timely-filed return, will qualify as W-2 wages attributable to a trade or business identified by the S corporation for purposes of applying the W-2 wage limitation.

Q10: What is the "unadjusted basis immediately after acquisition" (UBIA) of qualified property?

A10: A taxpayer's UBIA of qualified property is its basis in the qualified property on its placed-in-service date, *before* any adjustments except an adjustment to reflect a reduction in basis for the taxpayer's personal use of the property during the tax year. "Qualified property" for purposes of the QBID is any depreciable tangible property:

1. Which is held by, and available for use in, the taxpayer's trade or business at the close of the tax year;

2. Which is used at any point during the tax year in the production of QBI, and

3. The depreciable period for which has *not* ended before the close of the tax year.

The depreciable period ends on the *later* of 10 years after the property is first placed in service, or on the last day of the last full year in the applicable recovery period (i.e., so property in the MACRS 3-, 5-, or 7- classes are assured of having at least a 10-year period as UBIA) as long as they are still in service as of the close of the tax year.

> **Comment:** So, if an asset of any MACRS classification is sold or exchanged in a taxable transaction on the last day of the tax year (or, before), then it does *not* count toward the UBIA calculation for that tax year.

Q17: Is there a form for reporting the QBID? And if so, where can I find it?

A17: Yes, for tax years 2019 and after, **Form 8995, Qualified Business Income Deduction Simplified Computation**, and **Form 8995-A, Qualified Business Income Deduction**, are used to compute and report the QBID. Before 2019, there was no specific form. However, worksheets were available in the **Form 1040** Instructions and **Pub. 535, Business Expenses**, to assist with the calculations in 2018.

> **Comment: Form 8995** is used when the taxpayer's taxable income, before the Sec. 199A deduction, is below the end of the 24% marginal tax rate for their filing status. On the other hand, **Form 8995-A** must be used when the taxpayer's taxable income, before the Sec. 199A deduction, is beyond the end of the 24% marginal tax rate (i.e., and the taxpayer is therefore impacted by the phaseout rules).

Q28: What requirements must be met to make an election to aggregate *multiple* trades or businesses as *one* QTB and how does such aggregation election effect any election made to "group" activities under another Code section?

A28: To aggregate multiple trades or businesses, the following requirements must be met:

1. The same person or group of persons, directly or by attribution, own 50% or more of each trade or business for more than half of the tax year, including the last day of the tax year;

2. All the items attributable to each trade or business are reported on returns with the same tax year, without regard to short-tax years;

3. None of the trades or businesses is an SSTB, and

4. Two of the following three factors are met:

A. The trades or businesses provide products, property, or services that are the same or customarily offered together;

B. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources, and/or

C. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

Once an aggregation election is made, the aggregation must be consistently applied to the trades or businesses unless there has been a "significant change to the facts and circumstances that would render the aggregation no longer appropriate." Furthermore, an election to aggregate for QBID purposes has no effect on an the election to "group" under another Code section (e.g., such as for purposes of the passive loss rules under **Code §469**).

Q33: Does QBID reduce the adjusted basis of a shareholder in a S corporation or the adjusted basis of a partner in a partnership?

A33: No. The QBID has no effect on an S corporation shareholder's adjusted basis in its S corporation stock or a partner's adjusted basis in its partnership interest.

Q40: Are charitable contributions attributable to a trade or business for purposes of determining QBI?

A40: No. For purposes of determining QBI, QBI is *not* reduced by amounts that constitute charitable contributions under **Code §170** (e.g., where a partnership or an S corporation were to make a otherwise deductible charitable contribution at the entity level) since they are normally not considered to have been made in the normal course of the entity's trade or business. **(Code §199A; QBI Deduction)**

> **Comment:** Keep in mind that certain expenses such as interest expense on borrowed monies to either buy into, or make a capital contribution to, an S corporation or partnership (i.e., a flowthrough entity for which the K-1 results on reported on **Schedule E** of **Form 1040**) will reduce any net QBI reported by that entity (i.e., as per **Part IV** of IRS **Notice 89-35**). Also, unreimbursed expenses of a partner otherwise deducted on **Schedule E** would reduce QBI received from that partnership.

☞**Service Issues Additional FAQs on §199A Deduction for Rental Activities**

The IRS has issued a series of frequently asked questions (FAQs) regarding rental real estate that fails to satisfy the "250-hour safe harbor" requirement that automatically treats certain rental real estate businesses as "Sec. 162 trades or businesses" solely for the purposes of **Code §199A** "qualified business income deduction."

> **Note: This is a reminder that the "rental activity safe harbor" is still available for automatically meeting the Sec. 162 T/B standard.**

Background - §162 Trade or Businesses: Congress enacted **Code §199A** to provide a deduction to non-corporate taxpayers of up to 20% of the taxpayer's "qualified business income" (QBI) from each of the taxpayer's "qualified trades or businesses," including those operated through a partnership, S corporation, or sole proprietorship, as well as a deduction of up to 20% of aggregate qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income.

Code §199A(d) defines a "qualified trade or business" as any trade or business other than a "specified service trade or business" (SSTB) or the trade or business of performing services as an employee. **Reg. § 1.199A-1(b)(14)** defines a trade or business, in relevant part, as a trade or business treated as such under **Code §162** other than the trade or business of performing services as an employee.

Background - Rental Real Estate Safe Harbor: The IRS issued a revenue procedure that provides a "safe harbor" for taxpayers who seek to claim the deduction under **Code §199A** with respect to a rental real estate income. If the "250-hour safe harbor" requirement is met, the taxpayer's rental real estate business is treated as a *single* trade or business, as defined in **Code §199A(d)**, for purposes of applying the regs under **Code §199A**, including the application of the "aggregation rules" in **Reg. § 1.199A-4**. (**Rev. Proc. 2019-38**) However, this "safe harbor" specifically excludes rental real estate rented or leased under a "triple net lease."

Additional FAQs: The FAQs emphasize a number of additional points such as the fact that the safe harbor is *not* the only means by which rental real estate will be treated as a "§162 trade or business" for purposes of the QBI deduction. The other two ways are:

1. The rental real estate rises to the level of a "**Code §162** trade or business" (i.e., by examining the underlying facts and circumstances," or

2. The rental or licensing of property is to a commonly-controlled trade or business operated by an individual or a passthrough entity as described in **Reg. § 1.199A-1(b)(14)**. (**FAQ 50**)

The second way mentioned above is often referred to as a "self-rental" (**FAQ 48**), even though it does *not* entail that the lessor/landlord "materially participate" under the passive loss rules. Commonly-controlled trades or businesses are, in general, trade or businesses where one person owns 50% or more of each trade or business (directly, or indirectly due to the "attribution rules"). (**Reg. § 1.199A-4(b)(1)(I)**)

Comment: Once the "common control test" is met, all investors receiving any net rental income can treat it as QBI.

Even though triple net leases do *not* qualify for the "250-hour safe harbor," if rental real estate involving a triple net lease is otherwise treated as a trade or business under **Code §199A** (e.g., under the "controlled tenant/lessee" test), then the income, gains, losses and deductions would be included in QBI. (**FAQ 57**)

Comment: A possible solution to the IRS' insistence that triple net leases should *not* qualify as "Sec. 162 trades or businesses" (i.e., at least under the "facts-and-circumstances" test) would be to shift responsibility for the payment of insurance and annual taxes (in the case of real estate rentals) back to lessor/landlord so that only repairs and upkeep of the leased property remains the responsibility of the lessee/tenant. Arguably, a "triple net lease" situation is no longer present.

One of the FAQs asks that if rental real estate that is treated as a "trade or business" for purposes **Code §199A**, would this mean that its income should reported on **Schedule C of Form 1040 (Profit or Loss From Business (Sole Proprietorship))** (i.e., as opposed to **Schedule E**), and therefore be subject to self-employment tax? Absent "significant personal services" (i.e., such as would be the case with a hotel/motel, B&B, or short-term resort rental) being provided to the tenant, the answer to both questions is "no." In other words, how rental real estate is reported on **Form 1040** has *not* changed due to the QBI deduction. Rental real estate is usually reported on **Part I** of **Schedule E (Supplemental Income and Loss** (i.e., from rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)), and is *not* subject to self-employment tax. Even if rental real estate rises to the level of a **Code §162** trade or business, it is still generally reported on **Schedule E, Part I**, because rental real estate is generally excluded from self-employment taxable income under **Code §1402(a)(1)**.

As mentioned above, some rental real estate income is subject to self-employment tax (e.g., boarding house, hotel or motel, and bed and breakfast, where substantial services are rendered for the convenience of the occupants). Thus, this type of rental real estate income is subject to self-employment tax and should be reported on **Schedule C** (i.e., instead of **Schedule E**). (**FAQ 52**)

As opposed to the **Code §469** passive loss rules, **Code §199A** does *not* have a "material participation" requirement. As a result, eligible taxpayers with income from a qualified trade or business may be entitled to the QBI deduction regardless of their level of involvement in the trade or business. (**FAQ 54**) **(Code §199A; IRS FAQs)**

Qualified Opportunity Zones

Note: What follows is an extensive list of guidance items that have been released thus far regarding investments in Qualified Opportunity Zones.

☞**Boundaries of Qualified Opportunity Zones Not Subject to Change (Ann. 2021-10)**

The IRS confirmed that the boundaries of Designated Qualified Opportunity Zones were established at the time they were designated (i.e., based on the 2010 census) and are *not* subject to change (i.e., due to any changes resulting from the latest 2020 census). **(Code §1400-Z; QOFs)**

☞**Reporting Requirements for Opportunity Zone Investments**

Those taxpayers who held a "qualifying investment" in a Qualified Opportunity Fund (QOF) at *any* point during the tax year must file **Form 8997** with their timely-filed federal tax return (including extensions). Failure to file the form will result in a "rebuttable presumption of an inclusion event" that terminates the qualifying investment in a QOF. A corporation or partnership that elected or is electing to be a QOF must file completed **Form 8996** annually with their timely-filed federal tax return (including extensions) to report that the QOF meets the 90% investment standard of **Code §1400Z-2** or to calculate the penalty if it fails to meet the "investment standard." This is required even in years the corporation or partnership has no taxable income. **(Code §1400Z-2; QOFs)**

Comment: More information can be found on the IRS **website** for QOFs.

☞**Corrections to Reporting Sec. 1231 Gains on Form 8949 Reinvested into QOF (Form 8949 Instructions)**

The IRS has corrected the instructions on how to report the election to defer the taxation of gain upon the sale of Sec. 1231 property by rolling over the gain into a qualified opportunity fund (QOF). The Service has also corrected regarding how to report the inclusion of the gain in income when the QOF is sold.

Background - 1231 Gain: A Sec. 1231 gain is a gain from the sale of real or depreciable property that was used in a trade or business and held for more than one year.

Background - Potential Tax Benefits of QOF: Code §1400Z-2 provides, in general, that a taxpayer can defer recognizing the gain on the sale or exchange of an asset if the taxpayer rolls over the gain to a QOF (i.e., as defined under **Code §1400Z-2(d)(1)**). The taxpayer is required to elect this deferral on **Form 8949 (Sales and Other Dispositions of Capital Assets)**.

The **Instructions** to **Form 8949** provide details on how to elect such a deferral. And the instructions also provide details on how to report the inclusion of income upon the sale of an interest in a QOF, in accordance with **Code §1400Z-2(b)** and **Code §1400Z-2(c)**.

The 2020 instructions to **Form 8949** provide specific details regarding a Sec. 1231 gain. The instructions state that "Each QOF investment of Section 1231 gains will use two *separate* rows in **Part I** (i.e., short-term transactions) or **Part II** (i.e., long-term transactions), as applicable, of **Form 8949**." Upon the sale of an interest in a QOF that was purchased with the gains from a Section 1231 gain, the 2020 instructions to **Form 8949** say that "Each inclusion will use two separate rows in **Part I** or **Part II**, as applicable."

Comment: The deferral of the gain is reported on two separate rows in order to properly account for any gain that the taxpayer does recognize versus gain deferred. Likewise, for the inclusion of any gain, the two separate rows account for any gain that the taxpayer must recognize versus gain that is *not* recognized because of the rules. And, the correction discussed below does *not* change this two-row reporting.

IRS Correction: On its website, the IRS has corrected the above instructions. The "deferral instructions" should read, "Each QOF investment of Section 1231 gains will use two separate rows in **Part II** (i.e., long-term transactions) of **Form 8949**." And the "inclusion instructions" should read, "Each inclusion will use two separate rows in **Part II**." **(Code §1400Z-2; QOZs)**

Comment: The former instructions directed the taxpayer to report part of the deferral and part of the inclusion in **Part I** as a short-term capital gain. But, by definition, a Sec. 1231 gain can only be *long-term*. The IRS webpage now corrects this. The correction also makes some "non-substantive changes" to the way the deferral or inclusion is reported on **Form 8949**.

☞**Deadlines Extended for Qualified Opportunity Fund Investments (Notice 2021-10)**

This IRS Notice "provides additional relief" under **Code §7508A** for qualified opportunity funds (QOFs) and their investors in response to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic. This notice also provides additional relief pursuant to **Code §1400Z-2(f)(3)**. Specifically, this notice extends the relief for QOFs and their investors provided by **Notice 2020-39**. **(Code §1400Z-2; QOFs)**

☞**IRS Sending Letters Related to Qualified Opportunity Funds (IR 2020-274)**

The IRS has started sending letters to taxpayers "who may need to take additional actions" related to Qualified Opportunity Funds (QOFs). Taxpayers who attached or indicated they attached a **Form 8996 (Qualified Opportunity Fund)** to their return may receive **Letter 6250**. This letter lets them know that if they intended to self-certify as a QOF, they may need to take additional action to meet the annual "self-certification requirement." Additionally, taxpayers may receive **Letter 6251** notifying them that they "may *not* have properly followed the instructions" for **Form 8949 (Sales and Other Dispositions of Capital Assets)** or do *not* appear to have an "eligible gain" that would enable them to make a valid deferral election for gains invested in a QOF. These taxpayers should file an amended return or an **Administrative Adjustment Request (AAR)**. **(Code §1400-Z; QOFs)**

☞**IRS Updates Qualified Opportunity Zone FAQS (Opportunity Zones FAQs)**

The IRS has updated its frequently asked questions to discuss the definition of Qualified Opportunity Zone (QOZ) business property.

Background: Code §1400Z-1 allows for the designation of certain low-income community population census tracts as QOZs. QOZs are eligible for a number of favorable tax rules aimed at encouraging economic growth and investment in businesses within the zone. Specifically, **Code §1400Z-2** provides, at the election of the taxpayer (i.e., a "deferral election"), *temporary* deferral of inclusion in gross income for capital gains reinvested in a Qualified Opportunity Fund (QOF) and the *permanent* exclusion of capital gains from the sale or exchange of an investment in the QOF.

A QOF is, generally, an investment vehicle:

i. That is organized as a corporation or a partnership for the purpose of investing in QOZ property (other than another QOF), and

ii. That holds at least 90% of its assets in QOZ property. (**Code §1400Z-2(d)(1)**)

QOZ property includes: any QOZ stock, any QOZ partnership interest, and any "QOZ business property." **(Code §1400Z-2(d)(2)(A)**)

QOZ business property is tangible property used in a trade or business of a taxpayer if:

- The property was acquired by the QOZ business by purchase *after* Dec. 31, 2017;

- The original use of the property in the QOZ commences with the QOF or the QOF "substantially improves" the property; and

- During "substantially all" (i.e., at least 90% as per **Reg §1.1400Z2(d)-2(d)(3)(i)**) of the QOF's holding period for the property, "substantially all" (i.e., at least 70% as per **Reg §1.1400Z2(d)-2(d)(4)(ii)**) of the use of the property was in a QOZ. (**Prop. Reg. §1.1400Z2(d)-1(c)(4)**)

New FAQs: The IRS has added the following FAQs regarding the purchase, original use of property, substantial improvement, and "substantially all" requirements for property to be QOZ business property:

Q41: I contributed land located in a QOZ to a QOZ business. The QOZ business plans to construct a new building on the contributed land. Can the new building satisfy the requirement that it be acquired by purchase?

A41: Yes. The building is "QOZ business property," if it meets the following requirements:

a. It is intended to be used in a trade or business in a QOZ;

b. The materials used to construct the new building were "QOZ business property;" and

c. It is treated as acquired *after* 2017.

For this purpose, the newly-constructed building is acquired on the date "significant physical work" begins. The contributed land on which the building is located, however, is *not* QOZ business property because it was *not* purchased by the QOF.

Q42: When does "significant physical work" begin?

A42: This depends on the facts and circumstances. In this regard, "significant physical work" does *not* include preliminary activities such as planning or designing, securing financing, exploring, or researching. For example, if a factory is to be constructed on a site, preliminary activities include clearing or testing of soil condition. On the other hand, "significant physical work" begins, for example, when work starts on the excavation of footings or the pouring of pads for the factory.

Q43: Instead of purchasing equipment to use in my QOZ business, I wish to lease equipment. Can leased property qualify as QOZ business property?

A43: Yes. If the parties to the lease are unrelated, the leased property can qualify as "QOZ business property" but only if:

a. The lease for the property is entered into *after* December 31, 2017; and

b. The terms of the lease are market rate (i.e., the terms reflect common, arms-length market pricing in that location).

In addition, if the parties to the lease are related:

a. There must be no prepayment in connection with the lease that exceeds 12 months, and

b. If the leased property had been previously used in the QOZ, then, before the *earlier* of the last day of the lease, or 30 months after the receipt of tangible personal property under the lease, the business "must freshly purchase for use" with the leased property QOZ business property equal in value to the leased property.

Q45: I purchased a building in a QOZ that is currently vacant. Is the building "original use" property?

A45: Vacant property (including a building) is "original use property" if:

a. The property was vacant for an "uninterrupted period of three years" beginning *after* the date the IRS designated as a QOZ the census tract that contains the property; or

b. The property began to be vacant "at least one year prior" to the date when the IRS designated that census tract as a QOZ, and the property remained vacant through the date of the purchase.

Q46: What does it mean for property to be "substantially improved?"

A46: Property is "substantially improved" if, during *any* 30-month period beginning *after* the property is acquired, additions to the basis of the property exceed an amount equal to the adjusted basis at the start of the 30-month period.

Q47: A QOF purchased tangible property in a QOZ, and that property is currently undergoing "substantial improvement." Is the property "substantially improved" as QOZ business property for purposes of the 90% investment standard?

A47: If tangible property is undergoing improvement and its basis has *not* yet been doubled but the QOF "reasonably believes" that the property will be QOZ business property after improvements are completed, then during the 30-month substantial improvement period, the property counts as "substantially improved."

Q48: My QOF, or QOZ business, purchased a hotel that is located in a QOZ. Does the parcel of land on which my hotel building is located need to be "substantially improved?"

A48: If a building is used in the active conduct of a trade or business, you generally do *not* need to "substantially improve" the parcel of land on which the building is located. However, if the land is "unimproved or minimally improved," the land must be "substantially improved." Moreover, the land fails to be "QOZ business property" if it was purchased with an expectation that it would *not* to be improved "by more than an insubstantial amount."

Q49: The words "substantially all" appear twice in the definition of QOZ business property. Do these words have the *same* meaning in both places? If not, what are the two meanings, and how do they interact?

A49: "QOZ business property" is tangible property owned or leased by a QOF or QOZ business "that satisfies a variety of criteria." These criteria include requirements that, during "substantially all" of the time in which the QOF or QOZ business holds or leases the tangible property, "substantially all" of the use of that property by the QOF or QOZ business must be in a QOZ.

The first of these two "substantially all" references means *at least 90%*, and the second means *at least 70%*. Thus, during at least 90% of the time in which the QOF or QOZ business holds or leases the tangible property, at least 70% of the use of that property by the QOF or QOZ business must be in a QOZ. Applying these two definitions together means that, during the entire time in which the QOF or QOZ business owns or leases tangible property, at least 63% (i.e., 90% of 70%) of the use of that tangible property must be in a QOZ.

Q50: I and a few employees operate a landscaping business from a building located in a QOZ. My employees and I meet at our building, receive job instructions for the day, and transport our landscaping equipment to job sites located within QOZs as well as sites that are *not* located within QOZs. At the end of our job, we transport the equipment back to our building and carry out the rest of our job duties. Can my landscaping equipment qualify as QOZ business property?

A50: Yes. Mobile tangible property, such as your landscaping equipment, can qualify as "QOZ business property." Because you use your landscaping equipment in multiple census tracts, you must aggregate the number of days you use the tangible property in various census tracts. Generally, if you used your landscaping equipment at least 70% of the days in QOZs, your landscaping equipment is "substantially used in a QOZ." In addition, based on the way you use your landscaping equipment in your business, if you always return your landscaping equipment back to the building at least every 14 days, you qualify for a "safe harbor" (i.e., under **Reg. §1.1400Z2(d)-2(d)(4)(iii)**) that allows you to exclude up to 20% of your landscaping equipment from this 70% calculation. See the **instructions** to **Form 8996 (Qualified Opportunity Fund**).

Q51: Can inventory qualify as QOZ business property?

A51: Yes. Inventory (including raw materials) can qualify as "QOZ business property." However, you may choose annually to exclude inventory from QOZ business property and from the denominator of the applicable determination (whether 90% or 70%). During each tax year, whether you choose to include or exclude inventory from both QOZ business property and the denominator, you must treat all of your inventory consistently during that taxable year. **(Code §1400Z-2; QOZ)**

☞**IRS Provides Answers to Qualified Opportunity Funds FAQs and Impact of Coronavirus-Related Tax Relief (Notice 2020-39)**

The IRS has released guidance for Qualified Opportunity Funds (QOFs) and their investors in response to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic. This notice answers questions regarding relief from certain requirements under **Code §1400Z-2** such as the waiver of the 180-day requirement to invest realized gains into a QOF. In addition, the IRS has updated the Qualified Opportunity Zones **FAQs**. **(Code §1400Z-2; QOFs)**

☞**Reporting Sec. 1231 Property Gains for Qualified Opportunity Fund Investments (Form 8949)**

Guidance has now been provided as to how taxpayers should report the deferring of eligible gains from sales of Sec. 1231 property when they are reinvested in a qualified opportunity fund (QOF), as well as how to report the inclusion of those gains when the QOF investment is sold or exchanged.

Background: Code §1400Z-2 provides a few federal income tax benefits to eligible taxpayers that make longer-term investments of new capital in one or more designated qualified opportunity zones (QOZs) through QOFs and QOZ businesses (i.e., "qualifying investments"). One benefit is the ability of an eligible taxpayer, upon the making of a valid election, to defer until as late as December 31, 2026, the inclusion in gross income of certain gains that would otherwise be recognized in a tax year (i.e., "eligible gains") if the taxpayer invests a corresponding amount of the eligible gain in a qualifying investment in a QOF within a 180-day statutory period. (**Code §1400Z-2(a)**)

In December 2019, the IRS issued final regulations that include guidance for taxpayers investing eligible gains from Sec. 1231 property (i.e., depreciable or real property that is used in the taxpayer's trade or business or held for investment with a long-term holding period) in QOFs.

Eligible Gain Reporting: Taxpayers would defer eligible gains from Sec. 1231 property, including gains from installment sales and like-kind exchanges, by investing in a QOF which must be reported via a "deferral election" on **Form 8949, Sales and Other Dispositions of Capital Assets**, in the tax year of the deferral. And, for those taxpayers selling or exchanging a QOF investment, it too must be reported as the "inclusion of the eligible gain" on **Form 8949**.

Reporting Deferral Election: Each QOF investment of Sec. 1231 gains will use *two separate rows* in **Part I** (i.e., "short-term transactions") or **Part II** (i.e., "long-term transactions"), as applicable, of **Form 8949**.

- For the *first* row, in column (a), write **"QOF INVESTMENT FROM FORM 4797."** Leave columns (b) through (g) blank. In column (h), report the amount of the QOF investment from **Form 4797** as a *positive* number. For example, if ($75,000) was reported in column (g) of **Form 4797**, report $75,000 in column (h) of **Form 8949**.

- For the *second* row, in column (a), enter only the EIN of the QOF investment. In column (b), enter the date of the QOF investment. Leave columns (c), (d), and (e) blank. Enter code "Z" in column (f) and the amount of the deferred gain as a *negative* number (i.e., in parentheses) in column (g).

Reporting Inclusion Amount: Each inclusion will also use *two separate rows* in **Part I** or **Part II**, as applicable.

- For the *first* row, in column (a), write **"QOF INCLUSION EVENT FROM SECTION 1231 GAINS."** Leave columns (b) through (g) blank. In column (h), report the amount of the included Sec. 1231 gains from **Form 4797** as a *negative* number (i.e., in parentheses). For example, if $75,000 was reported in column (g) of **Form 4797**, report ($75,000) in column (h) of **Form 8949**.

- For the *second* row, enter the EIN of the QOF investment in column (a). Complete columns (b), (c), (d), and (e). Enter code "Y" in column (f), and in column (g) enter the amount of previously deferred gain as a *positive* number. **(Code §1400Z-2; QOZ)**

☞**IRS Rejecting Any Additional or Replacement QOZ Designations (Info. Ltr. 2019-0025)**

Under **Code §1400Z-1**, a state's governor (or, the mayor of Washington, D.C.) may nominate "certain low-income communities" for designation as **Qualified Opportunity Zones (QOZs)**. But, the nomination process was completed in 2018, and all designated QOZs can be found in **Notices 2018-48** and **2019-42**. In a recent **Information Letter**, the IRS was asked whether a particular census tract could either be designated as an *additional* QOZ or *replace* an existing QOZ. The IRS declined the request, noting that

Code §1400Z-1 does *not* allow for any additional or revised QOZ determinations *after* the maximum allowed number of zones in a state or territory have already been designated. **(Code §1400Z-1; QOZs)**

☞**IRS Issues Final Regs on Qualified Opportunity Zones (TD 9889)**

The IRS has released final regulations on investing in Qualified Opportunity Zones (QOZs). The final rules retain the general approach of regulations proposed on 10/28/18 and 5/1/19, but introduce certain modifications. Among other things, the final regulations (1) provide additional guidance on the election to temporarily defer the inclusion of certain eligible gain; (2) address the ability to increase the basis of a qualifying investment to fair market value after 10 years; (3) provide a list of income inclusion events and how to compute the income inclusion amount at the time of the event; (4) clarify how an entity becomes a Qualified Opportunity Fund (QOF) or QOZ business; and (5) provide additional guidance on the QOZ business property rules. According to the IRS, related forms, instructions, and other information needed to take advantage of the final regulations will be made available in January 2020. **(Code §§1400Z-1 & 1400Z-2; Opportunity Zones)**

☞**Revised Draft of Form 8996 for Qualified Opportunity Funds Released**

The IRS has released a revised draft of **Form 8996 (Qualified Opportunity Fund)**, which is filed *annually* by corporations or partnerships that are organized and operated as a Qualified Opportunity Fund (QOF). The revised draft, which *retains the first four parts* of the current version of **Form 8996**, features three additional sections (**Parts V-VII**). **Part V** lists every census tract where the taxpayer directly owns or leases Qualified Opportunity Zone (QOZ) business property. In **Part VI**, for every QOZ business in which the taxpayer holds stock or a partnership interest, the taxpayer must enter (1) every census tract in which the tangible property of the QOZ business is located and (2) the EIN of that business. **Part VII** is merely a continuation of **Part VI** to give the taxpayer more space to list census tracts. **(Code §1400Z-1; QOZs)**

☞**IRS Issues Additional Guidance Re: Deferral of Gains for Investments in Qualified Opportunity Fund (IR-2019-75)**

Proposed regulations have now been released that allow for the deferral of all or part of a gain that is invested into a Qualified Opportunity Fund (QO Fund) that would otherwise be includible in income. The gain is deferred until the investment is sold or exchanged (or, Dec. 31, 2026), whichever is *earlier*. But, if the investment is held for at least 10 years, investors may be able to *permanently* exclude gain from the sale or exchange of an investment in a QO Fund.

> **Comment:** What we are not hearing enough of is a discussion as to whether these investments make sense once you set aside the potential tax benefits. Why are these areas being designated as “Opportunity Zones” in the first place? Are they areas that have had trouble attracting investors in the past? More importantly, will the investor even see a decent return on their investment, or at least, a return of what they originally invested? Or, would they have been better off just paying the 15% or 20% capital gains tax and then sought a more conservative investment alternative?

“Qualified opportunity zone business property” is tangible property used in a trade or business of the QO Fund if the property was purchased *after* Dec. 31, 2017. The guidance issued thus far also confirms that tangible property acquired after Dec. 31, 2017, under a market rate lease to qualify as "qualified opportunity zone business property" if during “substantially all” of the holding period of the property, “substantially all” of the use of the property was in a qualified opportunity zone.

A key part of this newly-released guidance clarifies the "substantially all" requirements for the holding period and use of the tangible business property as follows:

- For the *use* of the property, at least 70% of the property must be used in a qualified opportunity zone

- For the *holding period* of the property, tangible property must be "qualified opportunity zone business property" for at least 90% of the QO Fund's or qualified opportunity zone business's holding period

- The partnership or corporation must be a "qualified opportunity zone business" for at least 90% of the QO Fund's holding period.

The proposed regs indicates that there are situations where deferred gains may become taxable if an investor transfers their interest in a QO Fund. For example, if the transfer is done by gift the deferred gain may become taxable. However, inheritance by a surviving spouse is *not* considered to be a taxable transfer, nor is a transfer, upon death, of an ownership interest in a QO Fund to an estate or a revocable trust that becomes irrevocable upon death. (**Code §1400Z-1, Qualified Opportunity Zones**)

☞**Additional FAQs on Qualified Opportunity Funds**

Regarding the final regs, the IRS has released the following FAQs:

- **What types of gains may be invested and when?** With regard to sales of business property, the proposed regs only permitted the amount of an investor's gains from the sale of business property that were greater than the investor's losses from such sales to be invested in QOFs, and required the 180-day investment period to begin on the last day of the investor's tax year. The final regs now allow a taxpayer to invest the entire amount of gains from such sales without regard to losses and change the beginning of the investment period from the end of the year to the date of the sale of each asset.

- **Partnership gain:** Partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and non-grantor trusts have the *option* to start the 180-day investment period on the due date of the entity's tax return, *not* including any extensions. This change addresses taxpayer concerns about potentially missing investment opportunities due to an owner of a business entity receiving a *late* Schedule K-1 (or other form) from the entity.

- **Investment of Regulated Investment Company (RIC) and Real Estate Investment Trust (REIT) gains:** The final regs clarify that the 180-day investment period generally starts at the close of the shareholder's tax year and provides that gains can, at the shareholder's option, also be invested based on the 180-day investment period starting when the shareholder receives capital gains dividends from a RIC or REIT.

- **Installment sales:** The final regs clarify that gains from installment sales are able to be invested when received, even if the initial installment payment was made *before* 2018.

- **Nonresident investment:** The final regs provide that nonresident alien individuals and foreign corporations may make Opportunity Zone investments with capital gains that are *effectively connected* to a U.S. trade or business. This includes capital gains on real estate assets taxed to nonresident alien individuals and foreign corporations under the Foreign Investment in Real Property Tax Act rules.

- **When may gains be excluded from tax after an investment is held for a 10-year period?**

- **Sales of property by a QOZB:** In the proposed regs, an investor could only elect to exclude gains from the sale of qualifying investments or property sold by a QOF operating in partnership or S Corporation form, but *not* property sold by a subsidiary entity. The final regs provide that capital gains from the sale of property by a QOZB that is held by a *subsidiary entity* may also be excluded from income as long as the investor's qualifying investment in the QOF has been held for 10 years. However, the amount of gain from such a QOF's or its QOZBs' asset sales that an investor in the QOF may elect to exclude each year will reduce the amount of the investor's interest in the QOF that remains a qualifying investment.

- Applicability to other gains: The final regs clarify that the exclusion is available to other gains, such as distributions by a corporation to shareholders or a partnership to a partner, that are treated as gains from the sale or exchange of property (other than inventory) for Federal income tax purposes.

- How does a QOF determine levels of new investment in a QOZ?

- Aggregation of property for purposes of the substantial improvement test: QOFs and QOZBs can take into account "purchased original use assets" that otherwise would qualify as qualified opportunity zone business property if the purchased assets:

(1) Are used in the *same* trade or business in the QOZ or a contiguous QOZ for which a non-original use asset is used, and

(2) Improve the functionality of the non-original use assets in the same QOZ or a contiguous QOZ.

In certain cases, the final regs permit a group of *two or more* buildings located on the *same* parcel(s) of land to be treated as a *single* property. In these cases, any additions to the basis of the buildings in the group are aggregated to determine satisfaction of the "substantial improvement requirement." As a result, a taxpayer need *not* increase the basis of *each* building by 100% as long as the total additions to basis for the group of buildings equals 100% of the initial basis for the group.

- Vacancy period to allow a building to qualify as original use: The final regs reduce the "five-year vacancy requirement" in the proposed regs to a "one-year vacancy requirement," if the property was vacant for at least one-year *prior* to the QOZ being designated and remains vacant through the date of purchase. For other vacant property, the proposed "five-year vacancy requirement" is *reduced* to three years. In addition, property involuntarily transferred to local government control is included in the definition of the term "vacant," allowing it to be treated as "original use property" when purchased by a QOF or QOZB from the local government.

- Leasing: The final regs provide several changes to leasing provisions in the proposed regs:

(1) State and local governments, as well as Indian tribal governments, will be exempt from the "market-rate requirements" for leased tangible property;

(2) Leases between unrelated parties are generally presumed to be at "market rate terms;" and

(3) Short-term leases of personal property to lessors using the property outside a QOZ may be counted as QOZBP.

- Working capital safe harbor: The final regs provide "several refinements" to the "working capital safe harbor:"

1. They create an "additional 62-month safe harbor" for start-up businesses to ensure that they can comply with the 70% tangible property standard, the 50% gross income requirement, and other requirements to qualify as a QOZB;

2. They provide that a QOZB can receive an extra 24 months to use working capital if the QOZ is in a Federally-declared disaster area;

3. They clarify that the safe harbor can only be used for a 62-month period and that amounts remaining

at the conclusion of the period cannot be counted as tangible property for purposes of the 70% tangible property standard; and

4. They allow a QOZB to treat equipment, buildings, and other tangible property that is being improved with the working capital as QOZBP that is "used in a trade or business" for purposes of the requirement that a QOZB must be engaged in a trade or business.

5. In addition, the final regs provide that a QOZB *not* utilizing the “working capital safe harbor” may treat tangible property undergoing the “substantial improvement process” as being used in a trade or business.

- Measurement of "use" for the 70% use test: The final regs provide that, if tangible property is used in one or more QOZs, satisfaction of the “70% use test” is determined by aggregating the number of days the tangible property in each QOZ is utilized. As a result, the final regs “set forth a clearer way” for determining satisfaction of the 70% use test, including a safe harbor for certain tangible property used *both* inside and outside the geographic borders of a QOZ.

- Determinations of location and "use" of intangible property: The final regs provide that intangible property qualifies as used in the QOZ if:

1. The QOZB's use of the intangible property is “normal, usual, or customary” in the conduct of the trade or business, and

2. The QOZB's use “contributes to the generation of gross income” for the trade or business.

Other clarifications regarding business property of QOFs or QOZBs:

1. Real property straddling census tracts: The final regs include *both* a “square footage test” and an “unadjusted cost test” to determine if a project is primarily in a QOZ, and provide that parcels or tracts of land will be considered contiguous if they possess common boundaries, and would be contiguous but for the interposition of a road, street, railroad, stream or similar property. Importantly, the final regs also extend the “straddle rules” to QOFs and QOZBs with respect to the “70% use test.”

2. Brownfield sites: The final regs provide that *both* the land and structures in a “brownfield site redevelopment” are considered to be “original use property” as long as the QOF or QOZB make investments into the brownfield site “to improve its safety and compliance with environmental standards.”

3. Self-constructed property: The final regs provide, in general, that self-constructed property can count for purposes of the QOF's “90% asset test” and the QOZB's “70% percent asset test.”

4. De minimis exception for “sin businesses:” The final regs provide that a QOZB may have less than 5% of its property leased to a “sin business.” For example, a hotel business of a QOZB could potentially lease space to a spa that provides tanning services.

> **Comment:** The obvious concern when one reads over these complex rules and where there is no licensing or oversight of operators of these QOZ funds, what happens if some of these requirements are *not* met? Did you just waste 10 years holding an investment that is now taxable (assuming that it even results in a gain), let alone the gain that you thought was deferred by initially investing in a QOZ? Would you have been better off just paying the 15% or 20% tax on the capital gains originally and not having the potential hassles resulting from a “defective QOZ?”

☞IRS Offers Additional FAQs on Qualified Opportunity Fund (Opportunity Zones FAQs)

The IRS has released more "frequently asked questions" regarding the tax deferral and capital gain exclusion possibilities of investing in a Qualified Opportunity Fund (QOF).

Background: Code §1400Z-1 allows for the designation of "certain low-income community population census tracts" as Qualified Opportunity Zones (QOZs). QOZs are eligible for a number of favorable tax rules "aimed at encouraging economic growth and investment in businesses within the zone." **Code §1400Z-2** provides, at the election of the taxpayer (i.e., a "deferral election"), *temporary* deferral of inclusion in gross income for capital gains reinvested in a QOF and the *permanent* exclusion of capital gains from the sale or exchange of an investment in the QOF.

A QOF is, generally, an investment vehicle:

i. That is organized as a corporation or a partnership for the purpose of investing in QOZ property (other than another QOF), and

ii. That holds at least 90% of its assets in QOZ property. (**Code §1400Z-2(d)(1)**)

QOZ property includes: any QOZ stock, any QOZ partnership interest, and any "QOZ business property." (**Code §1400Z-2(d)(2)(A)**) "QOZ business property" is tangible property used in a trade or business of a taxpayer if:

i. The property was acquired by the QOZ business by purchase after Dec. 31, 2017;

ii. The original use of the property in the QOZ commences with the QOF or the QOF "substantially improves" the property; and

iii. During "substantially all" of the QOF's holding period for the property, "substantially all" of the use of the property was in a QOZ. (**Prop. Reg. §1.1400Z2(d)-1(c)(4)**)

The *temporary* deferral of capital gains lasts until the *earlier* of:

1. The date the QOF investment is sold or exchanged, or

2. December 31, 2026. (**Code §1400Z-2(b)(1)**)

In the case of any investment in a QOF held by a taxpayer for *at least 10 years* and with respect to which the taxpayer made a deferral election, the basis of the investment equals the FMV of the investment on the date that the investment is sold or exchanged. (**Code §1400Z-2(c)**)

Comment: In other words, there would be no tax due on either the monies originally invested in the QOZ, or the return on this investment, as long as the taxpayer did *not* dispose of their interest before the end of the 10-year period.

In October 2018 and April 2019, the IRS issued proposed regs that provide guidance under **Code §1400Z-2** relating to gains that may be deferred as a result of a taxpayer's investment in a QOF, as well as special rules for an investment in a QOF held by a taxpayer for at least 10 years.

New FAQs: The IRS has added to its website FAQs regarding QOFs and QOZs, including discussions of the following:

- Investor adjusting basis to FMV: Suppose an investor made an investment in a QOF. After holding it for at least 10 years, the investor sells or exchanges it. Can the investor adjust the basis of the investment to FMV as of the date of the sale or exchange? Yes, but only if the investor made the investment in connection with a "proper deferral election." Also, the election must have remained in effect until that post-10-year sale or exchange. The FAQ also points out that the election did *not* cease to be in effect solely because, on December 31, 2026, the investor had to include in income the gain that had been originally deferred when he invested in the QOF.

Comment: It is a bit confusing as to what the IRS means when it says "the election must remain in effect," given that there is no provision for an investor to reverse a deferral election (with or without IRS approval).

Example: Suppose an investor had *ordinary* gain (e.g., due to depreciation recapture) from the sale of property in 2018. The investor invested the amount of that gain in a QOF. In 2029, the investor sells his interest in the QOF. The investor cannot adjust his basis to FMV because the gain (that was invested in the QOF) was *not* a *capital* gain. Therefore, his investment in the QOF was *not* made in connection with a "proper deferral election."

- List of QOZs: The FAQs point out that the list of designated QOZs can be found in **Notice 2018-48** and **Notice 2019-42**. In addition, a visual map of the census tracts designated as QOZs may also be found at IRS's **Opportunity Zones Resources** webpage.

- How to become a QOF: To become a QOF, an "eligible corporation or partnership self-certifies" by filing **Form 8996, Qualified Opportunity Fund**, with its federal income tax return. And, a limited liability company (LLC) that chooses to be treated either as a partnership or corporation for federal tax purposes can organize as a QOF.

- QOF business property: The FAQs say that, regarding "original use," tangible property is treated as being original use on the date first placed in service in the QOZ for purposes of depreciation or amortization. But, even *used* tangible property satisfies the original use requirement if the property has *not* been previously placed in service in the QOZ.

- Inventory in transit can be QOZ business property: Inventory of a QOF, including raw materials, does *not* fail to be used in a QOZ solely because the inventory is in transit from a vendor to the QOF or from the QOF to a customer. **(Code §1400Z-1; QOZs)**

☞**IRS FAQ Provides Relief for 2018 Qualified Opportunity Fund Investments (Opportunity Zones Frequently Asked Questions)**

The IRS, in this FAQ, has provided relief for investors who invested in 2018 in qualified opportunity funds (QOFs) *prior to* the publication of QOF "netting rules" that require an investor to net their capital gains against capital losses at the end of the tax year before they can invest in a QOF.

Background: Code §1400Z-1 allows for the designation of "certain low-income community population census tracts" as qualified opportunity zones (QOZs) eligible for a number of favorable tax rules "aimed at encouraging economic growth and investment in businesses within the zone.'

Code §1400Z-2 provides, at the election of the taxpayer, temporary deferral of inclusion in gross income for capital gains reinvested in a QOF and the permanent exclusion of capital gains from the sale or exchange of an investment in the QOF.

A QOF is, generally, an investment vehicle:

i. That is organized as a corporation or a partnership for the purpose of investing in QOZ property (other than another QOF) and

ii. That holds at least 90% of its assets in QOZ property. (**Code §1400Z-2(d)(1)**)

Code §1400Z-2(a)(1)(A) provides that the reinvestment of capital gains into a QOF must be done within a 180-day period beginning on the date of the sale or exchange that created the capital gain.

Proposed reliance regs issued in October 2018 emphasize that only "capital gains" (i.e., as opposed to gains from ordinary income, but including Sec. 1231 gains flowing from **Form 4797** to the **Form 8949** Schedule D worksheet) are eligible to be rolled over into QOFs. (**Prop. Reg. §1.1400Z2(a)-1(b)(2)(i)(A)**) In addition, the 2018 proposed regs state that some capital gains are the result of Federal tax rules deeming an amount to be a gain from the sale or exchange of a capital asset, and, in many cases, the statutory language providing capital gain treatment does *not* provide a specific date for the deemed sale. As a result, the 2018 proposed regs provide that, in general, the first day of the 180-day period set forth in **Code §1400Z-2(a)(1)(A)** is the date on which the gain would be recognized for Federal income tax purposes, without regard to the deferral available under **Code §1400Z-2**. (**Prop. Reg. 1.1400Z2(a)-1(b)(4)**) On the other hand, proposed reliance regs issued in May 2019 provide that the 180-day period for investing capital gains in a QOF begins on the *last day of the tax year*. Furthermore, the capital gain must be netted against any capital losses otherwise incurred during the year. This "netting process" also takes place at the end of the tax year. (**Prop. Reg. 1.1400Z2(a)-1(b)(2)(iii)**)

> **Comment:** An investor might have had a capital gain in 2018 and invested that capital gain in a QOF *before* the end of the year. By the end of the year, the investor might also have had some capital losses, which, when netted against the gains, would mean the investor had an overall net capital loss for 2018. Even though the investor acted *before* the 2019 proposed regs, these regs mean that the investor would have invested more than allowed under the QOF rules. A similar problem occurs because of the *change in the start* of the 180-day period from the 2018 proposed regs (i.e., last day of the tax year) to the 2019 proposed regs (i.e., actual date on which the capital gain would be realized and recognized for tax purposes).

IRS Position: The IRS has addressed the issue in one of the FAQs added at the end of a previously-issued list of QOZ FAQs. Specifically, the question asks what happens if, *before* the last day of an investor's 2018 tax year but during the 180-day period beginning with the realization of a **Code §1231** gain, the investor invested the amount of that gain into a QOF? The amount that the investor invested was less than his 2018 net **Code §1231** gain. The question further asks if the investor can make a valid deferral election based on that investment, even though proposed regs say that the 180-day period for his net **Code §1231** gain began on December 31, 2018? The answers that the IRS provide indicate that "yes," under these facts, because the investor's tax year ended *before* May 1, 2019 (i.e., the date the 2019 proposed regs were published), his QOF investment supports a "valid deferral election." And, making that election "will *not* impair the investor's ability to consistently rely on all other aspects of the 2019 proposed regs." **(Code §1400Z; Qualified Opportunity Zone)**

☞JCT Releases Slide Presentation on "Qualified Opportunity Zones"

The Joint Committee on Taxation (JCT) recently posted on its website a slide presentation titled **"Qualified Opportunity Zones (QOZ): An Overview."** The briefing addresses "four key aspects" pertaining to QOZ-investors, Qualified Opportunity Fund (QOF), qualified business, and qualified property. "Investors (i.e., any individual or entity) receive tax benefits by making an equity investment in a QOF which invests in areas designated as QOZs." A QOF is an entity "formed for the purpose of investing in a QOZ property," must be either a corporation (including a RIC or REIT) or a partnership, and "must have 90% of its assets invested in a QOZ property." A "qualified business," which has to be domestic, must satisfy a number of provisions. A "qualified property" consists of tangible property used in the trade or business of a QOF or qualified business that satisfies several key provisions. **(Code §§1400Z-1 & 1400Z-2; Opportunity Zones)**

> **Comment:** After some initial hesitation by taxpayers, the IRS reports that over $500 million has now been invested so far in this QOZs.

PARTNERSHIP/LLC TAXATION:

☞Proposed Regs Issued on Changes Made by TCJA to Holding Period Rules for "Carried Interest" (REG-107213-18)

> **Note: Congress has been considering an increase in the necessary holding period for "carried interests" from 3 years to 5 years in order to secure LTCG treatment, along with escaping employment taxes on such amounts.**

The **Tax Cuts and Jobs Act** added **Code §1061** which requires partnership interest derived from the performance of investment services (i.e., "carried interest") to be held for *more than three years* to be treated as long-term capital gains. The three-year holding period is required for sales of assets held (directly or indirectly) by the partnership, as well as for the sale of the partnership interest itself. Among other things, the proposed regulations clarify how to apply the holding period when a partner holds an API for less than three years, but the partnership sells an asset it held for more than three years. The proposed regulations also clarify that carried interests held by an S corporation are subject to the three-year holding period requirement. The regulations are proposed to apply to tax years beginning on or after the date they are adopted as final. However, for tax years beginning *after* 12/31/17, and *before* the regulations are adopted as final, taxpayers may generally rely on the proposed regulations provided they follow the rules in their entirety. **(Code §1061; Carried Interests)**

> **Comment:** For more information, see the **proposed regulations** and a **comparison** of changes to rules for carried interest under TCJA, on the application of **Code §1061**.

S CORPORATIONS:

☞Impact on S Corp's AAA Account Where Corp Converts to C Corp, Then Back to S Corp (*Tomseth*, 124 AFTR 2d 2019-5304 (DC OR, 9/27/19))

A district court has held that a C corporation that did *not* distribute its entire accumulated adjustment account (AAA) balance from a prior S corporation period within the "post-termination transition period" (PTTP) could *not* then distribute its remaining AAA balance tax-free *after* it re-elected S corporation status. **(Code §1368; AAA)**

> **Comment:** This decision highlights the importance of proper AAA planning for any S corporation, but particularly for those that might be contemplating a switch to C corporation status to take advantage of reduced 21% corporate tax rate. Taxpayers who do so thinking that they can re-elect following the normal five-year waiting period should recognize that any remaining AAA from the prior S period likely will be lost.

☞IRS Issues Proposed Regulations on Electing Small Business Trusts (REG-117062-18)

Because of changes made by the **Tax Cuts and Jobs Act**, a Nonresident Alien (NRA) is now permitted to be a potential current beneficiary of an Electing Small Business Trust (ESBT) (**Code**

§1361(c)(2)(B)(v)). To provide clarity on this new provision, the IRS has issued proposed regulations that would ensure S corporation income will continue to be subject to U.S. federal income tax when an NRA is a deemed owner of an ESBT. Specifically, the proposed regulations would modify the "allocation rules" under **Reg. §1.641(c)-1** to require that the S corporation income of the ESBT be included in the S corp portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules. The regulations are proposed to apply to all ESBTs after 12/31/17. **(Code §1361; ESBT)**

> **Comment:** Although the **TCJA** allows nonresident aliens to be beneficiaries of an ESBT, it is still clear that they could not invest directly in an S corporation and otherwise be an eligible shareholder. Doing so would otherwise void the S election.

TAX-EXEMPT ENTITIES:

☞IRS Issues Proposed Regs on UBTI "Silo" Rules for Tax-Exempt Organizations (IR 2020-78)

The IRS has issued proposed regulations (REG-106864-18) that provide guidance for tax-exempt organizations that are subject to "unrelated business income" tax with *more than one* unrelated trade or business on how to calculate their Unrelated Business Taxable Income (UBTI). The proposed regs provide guidance on identifying separate trades or businesses, including investment activities, as well as certain other amounts included in UBTI. Changes under the **Tax Cuts and Jobs Act (TCJA)** require tax-exempt organizations subject to the unrelated business income tax to compute UBTI *separately* for each trade or business. These are referred to as "silos." Starting in 2018, the loss from one trade or business is *not* permitted to offset the income from another, separate trade or business. **(Code §511; UBTI)**

ADMINISTRATIVE & PROCEDURAL MATTERS:

☞Additional Regs Issued on Bonus Depreciation (TD 9916)

The IRS has issued a second set of final regulations regarding the additional first year depreciation deduction (i.e., 100% bonus depreciation) under **Code §168(k)**. These final regs "reflect and further clarify the increased deduction and the expansion of qualified property," particularly to certain classes of used property, authorized by the **Tax Cuts and Jobs Act (TCJA)**.

> **Comment:** The bottom line is that in order for a *used* asset to qualify for the bonus depreciation, neither the taxpayer nor a predecessor may have had a "depreciable interest" in it at any time during the *five calendar years* before the taxpayer put it in service.

Background: Some of the more important clarifications dealt with the definition and issues surrounding "qualified improvement property."

- Qualified improvement property: Reg. §1.168(b)-1(a)(5) of the 2019 final regs defined the term "qualified improvement property" for purposes of **Code §168**.

- Predecessor and class of property: Reg. §1.168(k)-2(a)(2)(iv)(B) of the 2019 final regs defined a "predecessor" as including a transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor.

- Used property and partnership "five-year safe harbor:" Generally only property *not* previously used by a taxpayer qualifies for additional first year depreciation. (**Code §168(k)(2)(A)(ii)**) **Reg. § 1.168(k)-2(b)(3)(iii)(B)(1)** of the 2019 final regs provides that property is treated as used by the taxpayer or a predecessor at any time prior to acquisition by the taxpayer or predecessor if the taxpayer or the predecessor had a "depreciable interest" in the property at any time prior to such acquisition, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property.

The 2019 proposed regs clarify the extent to which a person is treated as having a "depreciable interest" in property by virtue of being a partner in a partnership that holds the property. The proposed regs amended **Reg. §1.168(k)-2** by adding **Prop. Reg. §1.168(k)-2(b)(3)(iii)(B)** to provide that a partner is considered to have a "depreciable interest" in a portion of property equal to the partner's total share of depreciation deductions with respect to the property as a percentage of the total depreciation deductions allocated to all partners with respect to that property during the current calendar year and five calendar years immediately prior to the partnership's current placed-in-service year of the property. For this purpose, only the portion of the current calendar year and previous 5-year period during which the partnership owned the property and the person was a partner is taken into account.

> **Comment:** One of the main take-aways with QIP is that these assets cannot be purchased from another taxpayer and qualified as MACRS 15-year property otherwise eligible for 100% bonus depreciation. Instead, it is the taxpayer (i.e., could be either the landlord or tenant in a rental arrangement) that must personally make the "qualified improvement."

The regulations also provide rules for (1) consolidated groups and (2) components acquired or self-constructed after 9/27/17 for larger self-constructed property on which production began *before* 9/28/17. (**Code §168; Bonus Depreciation)**

TCJA - SEC. 199A OVERVIEW:

☞Increased Penalty for Erroneous Sec. 199A Deductions

Although it is a generous tax break, the calculation of the 20% deduction for qualified business income should be done with some extra care, especially given the inherent complexities in the underlying rules. Namely, there is an increased penalty when this deduction is erroneously taken. Self-employed individuals, gig workers and K-1 recipients from partnerships, LLCs, S corporations and some trusts can deduct 20% of QBI, subject to restrictions for taxpayers finding themselves with a marginal tax rate beyond the end of the 24% bracket. When Congress enacted this tax break five years ago, it also made it easier for the IRS to assert penalties in audits of taxpayers who fail to comply with the requirements. As a result, the threshold for applying the accuracy-related penalty for substantial understatement of tax in these cases is the greater of $5,000 in extra tax or 5% (i.e., down from normal 10% threshold). (**Code §199A; Sec. 199A)**

☞IRS Finalizes QBI Safe Harbor for Rental Real Estate - Little Additional Guidance Provided (Rev. Proc. 2019-38)

The IRS has finalized a "safe harbor" under which a rental real estate enterprise will be treated as a "trade or business" for purposes of the Qualified Business Income (QBI) deduction under Sec. 199A. However, the safe harbor rules contained in this revenue procedure basically follow the proposed version found in **Notice 2019-7**, with very minor modifications. For example, under one of the changes in the final version, an interest in mixed-use property **may be treated as a *single* rental real estate enterprise or may be *bifurcated* into separate residential and commercial interests**. In addition, recordkeeping requirements are **a little less onerous** where "rental services" are performed by employees or independent contractors. The final version also retains the IRS's position that real estate rented under a "triple net lease" does *not* qualify for safe harbor protection. The same is true where the taxpayer exceeds the personal use limits found in **Code §280A** (i.e., the 14-day personal use limit, or, if greater, 10% of the days rented annually at FMV). This "revised" safe harbor applies to tax years ending *after* 2017, but taxpayers may instead choose to rely on **Notice 2019-7** for the 2018 tax year. Furthermore, the "contemporaneous records" requirement does *not* apply to tax years beginning *prior to* 1/1/20.

Comment: As described by the revenue procedure, "For rental real estate enterprises that have been in existence ***less than four years***, 250 or more hours of rental services are performed (as described in this revenue procedure) ***per year*** with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for **at least four years**, in **any three of the five consecutive taxable years that end with the taxable year**, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise."

Example: "Limitation on Use of Safe Harbor for Real Estate T/Bs"
John has owned his rental property for 3 years (e.g., 2016, 2017 and 2018). Since this is *less than four years*, he must have satisfied this "250-hour test" for *each of those years* in order to take advantage of this *revised* "safe harbor" that his rental activity meets the "Sec. 162 trade or business test" (even though 2018 would be the first year in which a Sec. 199A deduction could even be claimed).

Comment: IRS **Notice 2019-07** was less demanding since you would apparently only have to look at the 2018 tax year by itself (and, *not* each of the three years as in the **Example** above).

Example: "Four-year Use Requirement for Safe Harbor"
Lisa has owned her rental property for 5 years (e.g., 2014, 2015, 2016, 2017 and 2018). Since this is **four or more years**, she must have met this "250-hour test" for ***any of the three years*** during the 5-year period ending with the 2018 tax year in order to take advantage of the "safe harbor" that his rental activity meets the "Sec. 162 trade or business test" (even though 2018 would be the first year in which a Sec. 199A deduction could even be claimed). In other words, one would have to look at the **five most recent tax years** and satisfy the "250-hour test" for **at least three of them** (i.e., consecutive or not).

Comment: The use of this "safe harbor test" is *not* needed where a "self-rental" is involved (regardless of the type of entity to which the property is leased). In other words, such rentals are *automatically* considered to be "Sec. 162 trades or businesses," at least for those lessors/landlords who otherwise controlled (directly, or indirectly through the attribution rules) $\geq$ 50% of the tenant involved. Take note that unlike under the passive loss rules, there is no need for the lessor/landlord to "materially participate." So, once the tenant making these lease or rental payments is considered to be "controlled," *all* of the payments made qualify as QBI.

Comment: One thing that is not entirely clear under the Sec. 199A final regs concerning a "controlled self-rental situation" is whether just the portion of the rents received by the controlling LLC owners receives the automatic "Sec. 162 T/B status," or do all of the net rents paid out, for instance, to the LLC lessor/landlords receive this classification status? Since there is no language to the contrary, it would appear that once this "test" is satisfied, all rents would receive this "automatic" characterization.

☞Tainted SSTB Self-Rental Income Received by Commonly-Controlled LLC and Sec. 162 Automatic T/B Status

The *final* regulations do provide one exception to the "Section 162 trade or business" requirement for rentals. The *final* regs repeat the exception found in the *proposed* regs and state that a rental activity will be treated as a "Section 162 trade or business" if it is rented to a "commonly controlled" trade or business owned by the taxpayer (i.e., whether or not it is a non-SSTB, or an SSTB). In other words, a "self-rental" is automatically granted "de facto Section 162 status," even if the rental activity by itself might *not* have otherwise satisfied that standard.

Comment: To be "commonly controlled," the property must be rented to an individual or pass-through (i.e., but *not* to a C corporation), and the same owner (or, group of owners) must own $\geq$ 50% of both the property and tenant business. For these purposes, the 50% control standard is measured by using the attribution rules of **Code §§707** and **267**, which is different from what had been stated in the *proposed* regs. The *final* regs also clarify this rule by limiting its use to only those situations in which the related party is an individual or an RPE.

Comment: Keep in mind, though, when a rental activity is "pulled back into a commonly-controlled trade or business," that T/B might be a SSTB which means that the rents are now going to be treated *as an additional source of SSTB income* (i.e., this is the IRS attempt to shut down the "crack-and-pack" planning strategy). And, if the taxpayer is otherwise restricted on claiming a Sec.199A deduction with regard to QBI flowing from an SSTB (e.g., due to having taxable income exceeding the threshold amounts), this associated "tainted SSTB rental income" would be impacted as well.

Comment: The question has arisen where, for instance, an individual owns 100% of an S corporation which is a SSTB, and a building owned by an LLC controlled by this same taxpayer's family (e.g., spouse and children, but *not* the specific taxpayer operating the SSTB), will the rents nevertheless be additional "tainted SSTB income to these other family members?" With the application of the attribution rules mentioned above, the answer would be "yes" since it *would be the same* as the taxpayer actually owning the LLC solely in his or her name. But, instead, if the taxpayer only owned 50% of the lessor-LLC with other unrelated third-parties owning the remaining interests (i.e., the "control requirement" with regard to the tenant company would *not* be met), then only the share of the rent received by the SSTB owner as also one of the LLC-lessor owners would be tainted, while the rents received by the other LLC members would *not* be tainted. But, since the "controlled entity test" would *not* be satisfied, the rental would *not* be a deemed "Sec. 162 trade or business" as well (i.e., it would have to meet this "Sec. 162 T/B standard" under the facts-and-circumstances test, or the 250-hour IRS "safe harbor").

Comment: Rents are potentially eligible for the Sec.199A deduction regardless of what type of entity the tenant might be conducting their business as. Nevertheless, the "de facto status" of a rental activity meeting the **Code §162** standard as a "trade or business" will *not* be available if the tenant is a C corporation.

What happens, though, where there is a "mixture" of tenants and your "commonly-controlled trade or business" is just one of them? Does this "de facto status" as a T/B under Code §162 cover all of the rents flowing from the other tenants and therefore qualify all of the rents as QBI?

Example - "Commonly-Controlled T/B Is Sole Tenant"
A and B **own an S corporation (or, partnership) business**. They also own the LLC which holds title to the building where this business is the sole tenant. Under the "de facto rule" discussed above, the rental activity is *automatically* treated as a "trade or business" under **Code §162** and, therefore, the rents are treated as "qualified business income" (QBI) eligible for a potential 20% deduction under Sec. 199A.

Comment: Suppose A and B still own, for example, 60% of the building in the LLC, and C (an unrelated third-party) owns the other 40%. So, it is still a situation where A and B control both the tenant and landlord sides of the equation. Are only the rents going to A and B deemed as a "Sec. 162 T/B?" Or, would the share of the rents going to C as well meet this standard? Arguably, once the "control test" is met it would seem that all of the rents would meet the Sec. 162 T/B standard.

Example - "Commonly-Controlled T/B Is Just One of the Tenants"
Same facts as above, but A and B's T/B is just occupying 10% of the building's square footage while other third-party tenants occupy the remaining space. Apparently, the rent paid by this business would *automatically* be treated as QBI, while the other rental income would have to *separately* qualify by independently satisfying the "T/B standard" under **Code §162** based on facts and circumstances (or, possibly, under the "250-hour safe harbor" test).

Example - "Commonly-Controlled Business is a C Corporation"
Same facts as above, but A and B **operate their business as a C corporation**. Based on the statement in the regs, this "de facto status" as a "trade or business" under **Code §162** would *not* be available. Nevertheless, as with any rental income being received (i.e., from this business, or an unrelated third-party), it could still possibly be treated as "qualified business income" (QBI) given, at least according to the regs, that it was a "trade or business" under **Code §162** (i.e., based on facts and circumstances or under the IRS 250-hour "safe harbor").

Comment: If the tenant, for instance, is your commonly-controlled C corporation, an interesting question arises. Since it is *not* a flowthrough entity (i.e., partnership or S corporation), then **would the rents received by the LLC holding title to the rental property still be tainted as additional SSTB income (i.e., could the IRS argument against the "crack-and-pack strategy" still apply since it is *not* a flowthrough entity)?** In the absence of further guidance from the IRS, there is certainly an argument that **such rents are non-SSTB income**. Of course, the taxpayer would still have to, at least according to the reg writers, satisfy a "T/B standard" under **Code §162** for this rental activity. Moreover, **for every $25,000 of a Sec.199A deduction, they would need $1 million of UBIA**.

Example - Bare Ground Rentals to Commonly Controlled Ag/Horticultural Businesses
This *automatic* exception for applying the "Code §162 T/B standard" can be extremely useful where, for instance, bare ground is leased for a straight cash rent to a commonly-controlled agricultural or horticultural business and there is little in the way of UBIA (i.e., land with a few older fully-depreciated buildings). By not having the "rent expense" deduction on the T/B tax return, QBI is correspondingly increased. More importantly, though, with a properly executed "aggregation election," the "QBI component" for the rental income (20% x net rental income) can now be covered by any "wages" of the commonly-controlled trade or business (and, "wages" if needed for the "50% wage limitation test" are **20-times more valuable** than the presence of UBIA, which is only applied at a rate of just 2.5%).

For example, a commonly-controlled farming partnership (or, S corporation) has a $200,000 profit after paying to a SMLLC (i.e., Schedule E with the same H/W owners) holding title to the land and buildings $50,000 of rental expense. Assume that the buildings held by the SMLLC are fully depreciated as of the last day of the tax year (even though they are still in service), along with the fact that the land is nondepreciable. Meanwhile, the farming business has $100,000 of wages paid to rank-and-file employees. With the "automatic classification" of this rental activity as meeting the "Sec. 162 T/B standard" that is at least one potential limitation (at least according to the reg writers) out of the way. But, even more importantly, since the farming T/B and rental propereties are commonly controlled and assuming that they meet at least 2 out of the 3 factors needed, they can be aggregated for purposes of the Sec.199A deduction. As a result, there is now $250,000 of QBI in total to be considered and, with the 20% deduction, this equals a "QBI component" of $50,000. Not having to solely rely on UBIA to support a $10,000 "QBI component" had this rental activity remained separate from the T/B, the farmer can now take the entire $50,000 combined "QBI component" as a preliminary Sec.199A deduction. Even if they are over the end of the applicable phaseout range (i.e., $207,500 or $415,000 in 2018) since 50% x $100,000 wages = $50,000, it would be enough to support the "QBI component" of $50,000 (i.e., 20% x $250,000 QBI).

Comment: The only other "test" that would have to be met in order to list the $50,000 Sec.199A deduction on Line 9 of the farmer's 2018 Form 1040 would be that 20% of their taxable income over any "net capital gain," before any Sec.199A deduction, be in excess of the $50,000 deduction.

☞Rents as QBI - Draft Instructions to New 2019 Form 8995 Offer No Guidance

The IRS has released draft instructions for **2019 Form 8995 (Qualified Business Income Deduction Simplified Computation)** which do *not* add any significant guidance as to this issue of rental income being QBI. Instead, they only serve to reiterate the vague standards mentioned in both the proposed and final regs on Sec. 199A. The following summary attempts to pull together the information available in arguing that rental income, in most cases, will count as "qualified business income" for purposes of the Sec. 199A deduction.

Comment: There are some other clarifications/changes to note, however, in these **Form 8995** instructions that were *not* in either the proposed or final Sec. 199A regs. Namely, the following items serve to *reduce* QBI: (1) Interest incurred to purchase an interest in, or make a capital contribution to, a flowthrough entity (i.e., partnership/LLC or S corporation as discussed in **IRS Notice 89-35, Part IV**); (2) Charitable contributions which are separately stated on the K-1s; and (3) Unreimbursed partner expenses. Even though the tax prep software companies did *not* include these items as reductions of QBI for 2018 tax returns, a review should be done of where clients may have significant amounts involved (and, maybe amended returns should be filed). And, certainly for 2019 tax returns, they will be incorporated into all of the tax prep software packages.

Note: Going forward, these items continue to reduce QBI.

Comment: It is interesting to note that with regard to some of these clarifications, these draft instructions to **Form 8995** were issued in spite of the fact that in the preamble to the final Sec. 199A regs it stated that "The Treasury Department, as well as the IRS, decline to address whether **deductions for unreimbursed partnership expenses, the interest expense to acquire partnership and S corporation interest,** and state and local taxes are attributable to a trade or business as such guidance is **beyond the scope of these regulations**."

Looking at the language contained in **Code §199A(d)** (as well as the **TCJA Conference Agreement**), it states that "For purposes of this section, in general, the term "qualified trade or business" means *any* trade or business other than: (A) a specified service trade or business, or (B) the trade or business of performing services as an employee. There is **no specific mention of rental activities at all**. Therefore, **one must look to other sources in the Code** which treat rental activities as a "trade or business."

Comment: But, numerous newspaper and magazine articles written immediately after the passage of the TCJA stated bluntly that "rents" were added to the definition of QBI in order to secure the necessary votes needed to get this law through Congress (e.g., Senator Corker - TN and Senator Collins - ME). The final vote in the Senate was only 51 to 49 in favor of the law. Of course, the pundits also mentioned that President Trump would greatly benefit from the addition of “rents” to the definition of QBI, given all of the real estate that he holds. For example, one of the best articles on the TCJA written by Tony Nitti (**“Making Sense of the New Sec 199A Qualified Business Income Deduction”**) stated “On its surface, Section 199A will allow owners of sole proprietorships, S corporations and partnerships -- **and yes, even stand-alone rental properties reported on Schedule E** -- to take a deduction of 20% against their income from the business.” He went on to add, **“Here's what we know: clearly, the 20% deduction is intended to apply to rental income, because a last-minute change was made to the limitation on the deduction specifically to accommodate rental owners.”**

Comment: It would have made no sense just to add “rents” to the definition of QBI, if an “alternative test” based on capital investment (i.e., 2.5% x QBIA) was *not* added as well, since most rental schedules (i.e., **Form 8825** or **Schedule E**) are normally devoid of “wages.” This becomes critical for being able to take the Sec. 199A deduction anytime a taxpayer’s taxable income, before any Sec. 199A deduction, is above the applicable “threshold” (i.e., the end of the applicable 24% marginal tax bracket for the taxpayer).

Note: What follows is a discussion on whether “rents” constitute “trade or business income” so as to qualify as “Qualified Business Income (QBI)” which continues to be an issue for the 2021, as well as future tax years.

For example, **the net investment income tax rules of Code §1411 (i.e., for purposes of the 3.8% Medicare surtax as shown on Form 8960) also refer regularly to the concept of a "trade or business**," but those regulations: (1) Make clear that they are referring to a “Sec.162 trade or business,” and (2) **Give a great deal of leeway to allow rental owners to *not* have to try and navigate a century's worth of muddled case history in order to determine whether their rental activities rise to the level of a Section 162 trade or business.**

Generally, **Code §162(a)** allows a taxpayer to deduct “ordinary and necessary expenses” incurred in carrying on a “trade or business.” For an activity to be considered a “trade or business,” the taxpayer must:

1. Be regularly and actively involved in the activity;

2. Have begun the activity; and

3. Intend to make a profit from the activity.

Comment: A taxpayer's “sporadic participation” in an activity does *not* qualify as “regular and active involvement” in that activity. (***McManus*, TC Memo 1987-457**) As a result, it would be hard to argue that a taxpayer had QBI where they only tried to generate a limited amount of cash flow might by sporadically offering their vacation home on **“Vacation Rental by Owner”** or the **“Airbnb”** websites when they were not otherwise using it personally.

The Joint Committee on Taxation when they issued their **“General Explanation of the Tax Cuts and Jobs Act”** in Jan. 2019 stated that:

Courts have held that for an activity to rise to the level of constituting a trade or business, “the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit (p. 14).

Although in practice we sometimes see clients with “hobby businesses” which have little hope of ever generating a profit, rental activities (especially to unrelated outside third-parties) **are almost exclusively entered into with a motive to make a profit (or, at least generate a cash flow to cover expenses), as well as the expectation of future appreciation in the underlying asset(s).** And, if does *not* prove to be the case, the taxpayer will often dispose of the rental property and claim an ordinary (i.e., Sec. 1231) loss on **Form 4797**.

The JCT Explanation on the TCJA goes on to state:

> *An activity that is treated as a trade or business for* ***all relevant Federal income tax purposes*** *(and that keeps a separate and complete set of books and records) may be treated as a "qualified trade or business" (i.e., for Sec. 199A purposes).*

Thus, what follows along with some comments, are the respective Code sections which deal with as to whether rental activities should in fact be treated as a "trade or business" and therefore arguably generate "qualified business income" for Sec. 199A purposes:

- Code §162: "Ordinary and Necessary Trade or Business Expenses"

This Code section is probably the most important one to consider when arguing that rental activities produce "qualified business income." It allows for the deduction of **"ordinary and necessary trade or business expenses"** and **would specifically include rental deductions such as utilities, insurance, as well as maintenance and repair expenditures.**

> **Comment:** Deductions such as interest (**Code §163**), taxes (**Code §164**), losses (**Code §165**), depreciation (**Code §168**), immediate expensing (**Code §179**), etc. are dealt with under other specified Code sections.
>
> **Comment:** It is hard to imagine if one was to present an argument in Tax Court, for instance, that these aforementioned **Code §162** expenses (i.e., utilities, insurance and repairs) are directly related to a "trade or business," and the IRS would readily agree, **that the Service could come back with an assertion that the income stream on this *same* rental schedule (i.e., Form 8825 or Schedule E) that was being used to paid for these costs was *not* also being generated by a "trade or business." Can you have two separate and distinct approaches on the same rental schedule for the income v. the expenses?**

- Code §172: "Net Operating Loss Deduction"

Under **Code §172(d)(4)**, allowable losses stemming from depreciable property used in a trade or business, including real estate, can be used to create or increase a net operating loss. This would include rental losses *not* otherwise suspended under the at-risk basis or passive loss rules, and assuming the total NOL does *not* exceed the applicable $250,000/500,000 cap.

- Code §179: "Immediate Expensing"

New for the 2018 tax year, the **TCJA** now allows "assets used in connection with lodging" (even if it does *not* involve rentals to "transient dwellers" who average 30 days or less per stay such as with hotels, motels, bed and breakfast businesses, weekly resort rentals, etc.) to be immediately expensed. And, of course, the overall deduction cannot exceed any "trade or business taxable income" that the taxpayer might otherwise have. But, this **would include the amount of any net rental income** (which can be important where the taxpayer lacks other sources of such "T/B taxable income" such as wages or S/E income).

- Code §469: "Passive Activity Losses and Credits"

Under the regulations which set out what would constitute a "real estate trade or business" for purposes of classifying a taxpayer as a “real estate professional,” there are thirteen distinct items **which specifically include “rental activities.”**

- Code §1231: “Property used in a Trade or Business”

There are several tests which must be met in order that property is considered as being “used in trade or business.” They are: (1) It must be depreciable (or, amortizable); (2) It must have been held long-term (i.e., more than 1 year); and (3) **Would include real property “used in a trade or business.”** And, this last criteria **would include rental real estate**. That is why there would never be an objection by the IRS , given these requirements are met, **where a rental property is sold and Form 4797, “Sales of Business Property” is used to report the transaction.**

On the other hand, some Code sections set out that rental activities (including the mere holding of a real estate asset) might *not* rise to the level of being a trade or business:

- Code §355: “Divisive Re-Orgs”

Corporate clients may sometimes desire to get the title to appreciating real estate out of the corporation’s name and instead have it be held by the shareholders. **Code §311(b)**, however, prevents this transfer of title insomuch that it will treat it as a taxable sale or exchange where gain (but, *not* loss) will be recognized. And, as an alternative, dropping the asset down into a QSUB, for example, and then attempting to “spin-off” or “split-off” the stock of the QSUB to the shareholders will *not* work since an asset such as a building, by itself, does *not* constitute a “trade or business” eligible for this planning strategy (and, title would still be held in a corporation’s name in any event).

> **Comment:** And, if a single asset such as a rental property were to be sold, you would never have to execute a **Form 8594, Asset Acquisition Statement Under Sec. 1060"** which allocates a lump-sum purchase price among a group of assets constituting a trade or business since this singular sale of a building, for example, would *not* satisfy this T/B standard.

- Code §1402: “Self-Employment Tax”

Even the IRS, as well as the Sec. 199A regs, do *not* required that S/E tax be paid in order that a rental activity otherwise shown on Form 8825 or Schedule E be treated as a “trade or business.”

Various Types of Rental Activities & Sec. 199A Deduction:

It seems as though we have a number of distinct types of “landlords” based on the Sec. 199A final regs as follows:

A. Taxpayer with Just a Few Schedule E Rentals Whose Tenants Renew Their Leases on an Annual Basis.

> - These landlords have a few properties which they report on **Schedule E** (or, maybe to limit liability as H & W owning the property through an LLC and on **Form 8825**, at least in a common law v. community property state). They may even use a property management company for out-of-town rentals such as vacation homes at resort destinations.
>
> - They would almost never meet the “250-hour safe harbor” outlined in **Notice 2019-07**. So, they would have to look to “other relevant Code sections” to determine if they meet the “Sec. 162 T/B standard” in order to possible qualify for the new Sec. 199A deduction.
>
> **Example:** Jack and Shirley own a duplex in which they live in one unit with renters in the other unit. They have rented it for over 15 years, signing a new lease each year. Jack cuts the grass and

shovels the snow, along with doing other minor repairs. Shirley handles the accounting, finding new tenants when necessary and executing the leases. This time involvement by the couple amounts to maybe one or two hours each week. The property has appreciated nicely over the time that the couple has owned it, and it now has a significant positive net cash flow.

For purposes of this rental being a "Sec. 162 trade or business," have Jack and Shirley been involved (at least to the extent necessary) **on a "regular and continuous" basis over the last 15 years?** Just as important, **have they had an intent to "make a profit" during that time?** So, do the rents count as "qualified business income" for Sec. 199A purposes?

B. "Busy Professional" with Multiple Rental Properties

- This scenario might involve a busy professional such as a doctor, lawyer, dentist, accountant, etc. who invests in multiple rental properties and who spends much more time on an annual basis than the couple described above. Nevertheless, it is nowhere near the 250 hours needed to meet the IRS "safe harbor."

- Again, they would have to insist that Congress intended their rental income to qualify for the Sec. 199A deduction by looking to the "facts and circumstances" (as well as "other relevant Code sections," at least according to the **JCT Report**), including the fact that the very reason that they are allowed to deduct insurance, utility and maintenance costs is because this activity is arguably a "trade or business" under **Code §162**, as well as for other purposes under the Code (as discussed above).

C. Taxpayers Who "Eat, Sleep and Breathe Real Estate"

These landlords/lessors normally have no other significant sources of W-2 or self-employment income and derive a good deal of their overall gross income from rental properties. In addition, there is probably a good chance that they qualify as "real estate professionals" for purposes of the **Code §469** passive loss rules (i.e., > 750 hours and > 50% of their time in "real estate trades or businesses").

As far as the Sec. 199A deduction, **they need not worry about the "250-hour safe harbor" since that test is probably being met as well so that (at least on an aggregated basis) their rental activities are meeting the "Sec. 162 T/B standard."** Their bigger concern is that lacking any substantial "wages" on their rental schedules (even on an aggregated basis), **they need sufficient UBIA (which is only 5% as effective v. the "50% of wage test") in supporting an initial 20% deduction under Sec. 199A. In other words, for every $1 million of UBIA, this would only support just $25,000 with regard to a Sec. 199A deduction.**

D. "Self-Rentals" to "Materially Participating" RPE Business Owners

- The **"Sec. 162 T/B test" is *deemed* met for these owners**, especially where they are the *sole* tenants of the rental property. A question arises, however, when they only occupy a small percentage of the overall square footage of a building.

- Again, however, there must still be sufficient UBIA to support the initial Sec. 199A deduction, unless a proper "aggregation election" is made in which case the "wages" of the commonly-controlled business may be considered instead of the UBIA for support purposes.

Comment: Whether the rental activity meets the "trade or business standard under Code Sec. 162," there still will *not* be sufficient UBIA to support the initial Sec. 199A deduction **if the property**

in question has been sold during the tax year. Or, even if it is still on-hand and in service, **if the property has been fully depreciated** under whatever appropriate method the taxpayer is employing to write off the cost of the property, **there will likewise be no UBIA at yearend to support the Sec. 199A deduction**.

Comment: If there is a hesitation to claim a rental activity as meeting the "Sec. 162 T/B standard," taxpayers may be inclined to instead invest in real estate through a "real estate investment trust" (REIT) where there is no such standard necessary to claim the Sec. 199A deduction. Moreover, there is no need to have any "wages" or "UBIA" to support this deduction (and there would certainly not be any time commitment as with owning the rental real estate personally).

The *final* regulations do provide this one exception to the "Section 162 trade or business" requirement for rentals. The *final* regs repeat the exception found in the *proposed* regs and state that a rental activity will be treated as a "Section 162 trade or business" if it is rented to a "commonly controlled" trade or business owned by the taxpayer (i.e., whether or not it is a non-SSTB, or an SSTB). As stated above, a "self-rental" activity is automatically granted "de facto Section 162 status," even if the rental activity by itself might *not* have otherwise satisfied that standard (i.e., it is a "triple net lease" arrangement).

Comment: To be "commonly controlled," the property must be rented to an individual or pass-through (i.e., but *not* to a C corporation), and the same owner (or, group of owners) must own ≥ 50% of both the property and tenant business. For these purposes, the 50% control standard is measured by using the attribution rules of **Code §§707** and **267**, which is different from what had been stated in the *proposed* regs. The *final* regs also clarify this rule by limiting its use to only those situations in which the related party is an individual or an RPE.

Comment: Keep in mind, though, when a rental activity is "pulled back into a commonly-controlled trade or business," that T/B might be a SSTB which means that the rents are now going to be treated as an additional source of SSTB income. And, if the taxpayer is otherwise restricted on claiming a Sec. 199A deduction with regard to QBI flowing from an SSTB (e.g., due to having taxable income exceeding the threshold amounts), this associated rental income would be impacted as well.

Comment: The question has arisen where, for instance, an individual owns 100% of an S corporation which is a SSTB, and a building owned by an LLC controlled by this same taxpayer's family (e.g., spouse and children, but not the specific taxpayer operating the SSTB), will the rents nevertheless be additional "tainted SSTB income?" And, with the application of the attribution rules mentioned above, the answer would be "yes" since it would be the same result as if the taxpayer actually owning the LLC solely in his or her name. But, instead, if the taxpayer only owned 50% or less of the lessor-LLC with other unrelated third-parties owning the remaining interests, then only the share of the rent received by the SSTB owner as also one of the LLC-lessor owners would be tainted, while the rents received by the other LLC members would *not* be tainted.

Comment: Rents are potentially eligible for the Sec. 199A deduction regardless of what type of entity the tenant might be conducting their business as. Nevertheless, the "de facto status" of a rental activity meeting the Code §162 standard as a "trade or business" will *not* be available if the tenant is a C corporation.

What happens, though, where there is a "mixture" of tenants and your "commonly-controlled trade or business" is just one of them? Does this "de facto status" as a T/B under Code §162 cover *all* of the rents flowing from the other tenants and therefore qualify the rents as QBI?

Comment: Refer to the discussion in the article above (starting on page) to examine the various types of rental situations where the landlord also controls > 50% of the tenant T/B paying the rents.

E. "Personal Property Rentals" and "Triple Net Leases"

Be careful with situations involving "personal property rentals" (PPRs). Since they do *not* involve the rental of real estate (or, tangible personal property in connection with real estate), **Schedule E** cannot be used. Nevertheless, it should *not* be automatically assumed that **Schedule C** should be used **unless a "trade or business" is actively being conducted** (which usually is *not* the case where the property in question is *not* being rented or otherwise made available to the general public (and, S/E tax should *not* be incurred)). **Instead, PPRs should be treated as "Other Income/Loss" (which is now shown on Form 1040, Schedule 1, Line 21.** This is covered in more detail in an example below. But, the bottom line is that a "trade or business" is probably *not* being conducted. As a result, the rental or lease income is arguably *not* "qualified business income" for purposes of the Sec. 199A deduction.

Example: Tom owns 100% of a trucking company which is operated as an S corporation. On the advice of his attorney he now has over 50 rigs valued at approximately $200,000 each titled in the name of a SMLLC that he also owns. Currently, the tracker/trailers are rented on a "triple net lease" basis with insurance premiums, any taxes, as well as repair and maintenance costs handled by the S corporation.

The position of the IRS (based on ***Neill*** and **Rev. Rul. 73-522**) is that "triple net leases" are basically one step away from being "portfolio income" and, therefore, **would *not* be counted as QBI for Sec. 199A purposes**. One possible suggestion might be to shift responsibility for payment of the monthly insurance premiums (e.g., through an ACH arrangement), along with any taxes, over to Tom the lessor here. Would that successfully take it out of the definition of a "triple net lease" and enable the net lease payments to be now treated as "qualified business income?" **But, absent some modification of the terms of this triple net lease, though, the IRS would most likely object to the net lease payments being QBI.**

Regardless of whether triple net lease payments are QBI or not, the argument is that TNL arrangements such as this one do *not* involve an active "trade or business" and, therefore, they should be reported as **"Other Income"** and *not* on **Schedule C**. The "trade-off" is that a 20% QBI deduction is lost at a savings of 15.3% (or, 2.9%) self-employment tax (i.e., on $100 of lease income, a 20% QBI deduction would save a maximum of $7.40 in income tax, assuming the highest ordinary marginal rate of 37% (37% x $20 *not* being taxed) v. $15.30 (or, $2.90) of S/E tax (15.3% or 2.95 x $100) - but approximately one-half of any S/E tax would be an additional income tax deduction).

Comment: If this triple net lease had instead involved the rental of real estate, then there would be no question that it would be reported on **Form 8825** or **Schedule E** and, as such, would *not* involve any possible imposition of self-employment tax. **Nevertheless, the IRS would probably still assert that this type of net rental income would *not* be QBI, if a triple net lease arrangement was being used.**

F. "Sporadic Rentals with Airbnb or VRBO"

This scenario represents probably the weakest argument for any net rents being QBI since it *not* a "regular and continuous trade or business" nor one that entails much involvement by the lessors. Of course, if the rental is longer-term, for example, the entire winter season in FL, and normally done every year, perhaps it would come closer to meeting the "tests" set out by the various courts regarding this

"Sec. 162 trade or business" issue.

G. "Condominization of Hotel Units"

Sometimes hotels sell off their rooms on a "condo basis." For example, clients have owned 10 or 15 rooms in a resort hotel which they placed with the front desk that then handles all of the day-to-day responsibilities. But, since this is a "page one trade or business" (i.e., it would be reported on page one of **Form 1120S** or **Form 1065**), there is no question that any net profits are QBI for Sec. 199A purposes.

Rents as QBI - Conclusions: Probably, the **weakest of the arguments would involve sporadic rentals, such as Airbnb or VRBO, triple net leases and "personal property rentals"** when it comes to asserting such rental income is "qualified business income" for purposes of the Sec. 199A deduction. It is interesting to note that **if a taxpayer in fact had net rental losses in any of these three distinct scenarios, then they would probably argued that the rental activity was *not* a "Sec. 162 trade or business" since such losses would only have served to reduce QBI from other sources.**

☞**Do Director's Fees Count as "Qualified Business Income?"**

A client has **Form 1099 - MISC** board of director fees from three different manufacturing companies that total in excess of $350,000. Under **Code §162**, is this a "trade or business" such that this income would be a source of QBI? In the past, the taxpayer consistently used **Schedule C** (i.e., v. "Other Income") to report this gross income, while deducting related expenses. Self-employment tax was also paid on the net amount. As a side-note, a determination would have to be made as to whether being a director for these companies falls under the classification of a SSTB (i.e., since you are being specifically paid to render "advice and counsel" to these companies that you serve).

With regard to question on director's fees, they normally are *not* counted as "employee compensation," but a review of this Tax Advisor **article**, while a Google search using the terms "directors fees self-employment tax," will yield some additional guidance. So, the question becomes just because "Other Income" might be subject to S/E tax, is it QBI for purposes of **Code §199A**? When one looks at **Schedule E** rental income, for instance, just because it is *not* shown on **Schedule C** instead (e.g., had it been a T/B such as a hotel, motel, or B&B), does *not* preclude it necessarily from being QBI. But, on the other hand, does paying S/E tax automatically make it QBI?

Under **Code §162** (once again, the "standard" that the **Code §199A** reg writers are thrusting upon us), to be a "business" for tax purposes means that it is a "regular, continuous and substantial" activity of the taxpayer. So, what is the level of involvement here where $350,000 is being paid for this director's services to various corporations? Does it rise to the level of being a T/B? The bottom line unfortunately, is that the guidance under **Code §199A** is *not* clear.

Nevertheless, at this point, a strong argument could be made to treat it as QBI while advising the client that the IRS (if it ever has the resources to audit what the breakdown and justification of the **Code §199A** deduction is on **Line 9** of the **Form 1040**) might question it down the road. Certainly, the payment of S/E tax is one supporting argument that this is *not* some sort of "investment income" which would *not* be eligible for **Code §199A**. And, should it matter that these director fees are reported on **Schedule C** v. **"Other Income"** (**Line 21** of **Schedule 1**)? **(Code §199A; Director Fees)**

> **Comment:** If these services as a company directive offering "advice and counsel" were to be classified as a "specified service trade or business" (SSTB), then the **Code §199A** deduction issue becomes moot, since the taxpayer's taxable income (at least in this instance where $350,000 was received), before any **Code §199A** deduction, is likely in excess of the end of the MFJ "phaseout range" of $415,000 for 2018.

Note: The following excerpt is taken from the **"2022 Real Estate Taxation Guide"** which is available for purchase by your firm's tax department. Details are included at the end of this newsletter . . .

☞**Sec. 199A Issues Confirmed/Answered in Final Regs: The *final* Sec. 199A regs did answer a number of questions, while also affirming various issues addressed in the proposed regs**. These include:

1. **Two Separate and Distinct Categories of Income Eligible for Sec. 199A Deduction:** If you were to picture a "T-account," the "debit side" would list QBI from: (1) non-SSTBs; (2) SSTBs; and (3) net rental income (which can, at times, be classified as coming from *either* an SSTB or a non-SSTB). Meanwhile, on the "credit side," you would list REIT dividends and net PTP income. Technically, these *latter* items are *not* sources of "qualified business income." But, Congress saw fit to make them also eligible for the 20% deduction accorded under **Code §199A**.

> **Comment:** Normally, you will only have a "positive" source of income from the aforementioned "credit side" of this T-account. That is, you will either have REIT dividends, or not, in a given tax year. And, the same is usually true with PTP income as well, because if there is a PTP loss, it can only be offset with income from that *same* PTP (otherwise, it is suspended in the meantime on **Form 8582**). The only exception would be in a year when a PTP with a current (or, suspended) loss is disposed of in a fully taxable transaction (i.e., it is freed up under the PAL "disposition rule").

2. **Application of "Wage" and "Capital" Limitations:** Once a taxpayer has taxable income, before any Sec. 199A deduction, beyond the end of the respective phaseout ranges (i.e., $220,050 for unmarried taxpayers, including MFS filers, and $440,100 for MFJ filers for 2022), these "limitations" (i.e., the *greater* of 50% of wages, or 25% of wages + 2.5% of capital) are fully implemented. As a result, the initial "QBI component" (i.e., 20% x QBI for each separate T/B, unless an aggregation is made) must be entirely supported by the *greater* of these two limiting factors.

> **Comment:** Keep in mind that **there are no such "limitations" with regard to the Sec. 199A deduction allowed for REIT dividends or PTP income.** In other words, it does *not* matter how much taxable income is reported on **Form 1040** when it is this type of income against which the 20% Sec. 199A deduction is applied.

> **Comment:** And, regardless of the level of the taxpayer's taxable income, *before* any Sec. 199A deduction (and, where the Sec. 199A deduction was coming from - that is, QBI from the "debit side," or REIT dividends or PTP income from the "credit side"), **every taxpayer must have sufficient taxable income in excess of any "net capital gains" to support the final Sec. 199A deduction to be listed on Line 9 of the Form 1040.**

Treatment of Net Overall "Qualified Business Losses" on Either Side of the "T-Account" If the "debit side" from T-account analysis above has an overall "qualified business loss" (QBL), it must be carried over and used to offset any QBI in future tax years until it is fully exhausted from these *same* aggregate "debit-side" sources of QBI. Likewise, any overall QBL from the "credit side" must also be carried over until it is fully offset by the aggregate total of net REIT dividends and/or PTP income. As a result, the key thing to remember is that these respective sources of QBL carryover do *not* serve to decrease net income from the "other side " of the T-account. In other words, they can only reduce QBI if they originally arose from that category, and the same is true of QBLs arising from the dispositions of PTP holdings (i.e., on the "credit side").

- **Examples Illustrating above Rules:** Review the following examples to understand the implementation of the above rules, while also realizing that just because a taxpayer has taxable income, *before* any Sec. 199A deduction, above the end of their respective phaseout range and therefore cannot offset any SSTB income, it does *not* mean that they will *not* have other sources of income (i.e., non-SSTB income and rents, along with REIT dividends and PTP income) which can result in a potential Sec. 199A deduction.

Example #1: "Sec. 199A Deduction for High-Income Owners of SSTBs"
An married orthopedic surgeon owns 100% of an S corporation medical practice. But, since this business is in the "field of health" and the fact that the surgeon's taxable income on their joint return will be far above the end of the MFJ "phaseout range" (i.e., $440,100 for 2022), there will be no chance for a Sec. 199A deduction, given that this source of the QBI is from "specified service trades or business." In other words, once a married taxpayer has taxable income of $440,100 **before any Sec. 199A deduction** and all of their QBI is from an SSTB, the **"applicable percentage" for purposes of Sec. 199A goes from 20% down to 0%**. Therefore, it would *not* matter if they otherwise had sufficient "wages" or "investment in capital" to cover a potential 20% Sec. 199A deduction.

Comment: So, if a self-rental property was leased to this controlled SSTB corporation where this medical practice was the sole tenant, all of the net rental income would likewise be treated as additional SSTB income.

Comment: In the final regs, **ownership in a surgical center does *not* necessarily equate to a business "in the field of health."** It is not uncommon for surgeons to also own an interest in an LLC that leases a building to a group of surgeons. But, if only real estate is being provided and the doctors otherwise provide all of the professional services and employees needed to run the surgical center, then the *final* regs now offer an example (discussed below in the SSTB clarifications) that this rental income might *not* be tainted as additional "SSTB income." Of course, this assumes that the LLC holding the real estate and the SSTB surgery practice to which the building is being rented are *not* under "common control."

Example #1 (Cont'd.): "Sec. 199A Deduction for High-Income Owners of SSTBs w/ Rental Income & Non-SSTB Income" Assume that this taxpayer **also receives $300,000 of net rental income from various investment properties, as well as $300,000** from other K-1 trade or business investments (whether or not these sources of income were treated as passive under the **Code §469** PAL rules). As mentioned above, assuming his taxable income on a joint return is well over the end of the phaseout range (i.e., $440,100 for 2022), **he would *not* be entitled to any Sec. 199A deduction for the QBI received from the SSTBs in the "field of health." Nevertheless, as long as he has sufficient "wages" or UBIA, he might still be able to claim a Sec. 199A deduction on his rental income, along with the K-1 income flowing from his other business investments.**

Comment: As seen in the **Example** below, if the taxpayer also had any net PTP income, along with any REIT dividends, **he would also receive an additional Sec. 199A deduction, regardless of the level of his taxable income, and without any limitations based on "wages" or UBIA.**

Example #1 (Cont'd.): "Sec. 199A Deduction for High-Income Owners of SSTBs w/ REIT Dividends or PTP Income"
Assume that the orthopedic surgeon **also has $100,000 of REIT dividends along with $50,000 of PTP income**. This portion of the Sec. 199A deduction calculation (i.e., from the "credit side" of the T-account) is **completely separate** from the **Examples** above where the deduction was

unavailable. In other words, any SSTB income due to the taxpayer's high level of taxable income **has no effect on this second (but, separate) calculation**. With this latter type of QBI, **there are no phaseout rules, and no "limitation tests" based on wages or investment in capital.** As a result, you would simply take the aggregate $150,000 of QBI from the REITs and PTPs, multiple by 20% and deduct $30,000 (i.e., **on Line 13 of the 2021 Form 1040**) in arriving at the final taxable income number for this couple.

Example #2: "Negative QBI from REITs and PTPs Has No Impact on QBI from Other Sources"
In **2022**, an married accountant has **$340,100 of taxable income and QBI**, *before* any Sec. 199A deduction, and it is **made up of "debit side" $290,100 QBI** and **$50,000 from the REIT dividends (i.e., from the "credit side")**. The taxpayer also has a **$100,000 loss from a PTP**. Given that there is **no passive income from that specific PTP**, the $100,000 loss is suspended on **Form 8582** (and, will be until sufficient passive income **from that same PTP** exists to free up the $100,000 loss, or the taxpayer disposes of their *entire* interest in the PTP in a *fully-taxable* transaction). As a result, the taxpayer would be allowed a 20% Sec. 199A deduction (i.e., 20% x $340,100 QBI = $68,020), and with being in a 24% MFJ marginal tax bracket (i.e., 24% bracket runs from $178,150 to $340,100 of taxable income), **this would result in a tax savings of $16,325**.

Example #2 (cont'd.): Assume that in **2023**, the taxpayer disposes of their *entire* interest in the PTP, while also receiving $50,000 again from their REIT dividend investments. Now, the $100,000 of 2022 suspended loss from the PTP would be freed up and subtracted fully on page 2 of Schedule E. Furthermore, for purposes of the Sec. 199A deduction, it would offset the REIT dividends. **As a result, there would be no Sec. 199A deduction for this taxpayer in 2023 (assuming that they have no other sources of QBI).** In addition, this "excess" $50,000 of loss resulting from the sale of the PTP would have to be carried over to **2024** and would offset any REIT dividends or PTP income from other sources. It would not, however, have any effect on the Sec. 199A deduction calculation from other sources of QBI such as SSTB income, non-SSTB income or rents.

Comment: So, if this taxpayer from **Example #2** above continued to have $340,100 of taxable income in **2022** coming entirely from QBI sources (i.e., the "debit side" of the T-account), they **would still enjoy a $68,020 Sec. 199A deduction which would *not* be offset in any way by the QBL stemming from the net $50,000 loss on the disposition of the PTP interest** (i.e., from the "credit side" of the T-account).

Example #3: "Negative QBI from Non-REIT and PTP Sources Has No Impact on QBI from REITs and PTPs"
A taxpayer has **"negative QBI" of $100,000 from a business investment** (i.e., it could a passive or nonpassive, SSTB or non-SSTB, flowthrough entity). He **also has $50,000 of REIT dividends and $50,000 of PTP income**. Regardless of his taxable income *before* any Sec. 199A deduction, he will received a $20,000 (20% x $100,000 REIT/PTP QBI) deduction. Furthermore, the **$100,000 of "negative QBI" from the non-REIT/PTP sources will only serve to reduce non-REIT/PTP QBI as a carryover in the subsequent tax year**.

Comment: If the "negative QBLof $100,000" is from a passive activity, or the taxpayer cannot otherwise use it fully in offsetting their income from other sources due to the lack of basis (or, at-risk basis as shown on **Form 6198**), **then it would be suspended for that current tax year**. As a result, **it would no effect on the Sec. 199A calculation for *any* other sources of QBI (SSTB or non-SSTB income, or rents), as well any REIT dividends or PTP income (i.e., until such**

time as it frees up for purposes of calculating taxable income).

4. "Net Capital Gains" Broadly Defined: The **final step in calculating the Sec. 199A deduction is to compare 20% of the taxpayer's taxable income *before* the deduction, but in excess of any "net capital gains,"** to see if this net amount of taxable income is at least equal to (or, in excess of) the potential Sec. 199A deduction. The reason for this final "cap" on the Sec. 199A deduction is that a taxpayer is *not* going to be accorded a special lower marginal tax rate (e.g., 15%, 20%, 25% or 28%) on sources of taxable income such as: (1) net LTCG; (2) Sec. 1231 gains, included "unrecaptured Sec. 1250 gain;" (3) qualified dividends; and (4) gains from the sale or exchange of "collectibles," while also receiving a 20% deduction under Sec. 199A.

"Net capital gain" is defined in **Code §1(h)**, but the *proposed* regs did *not* contain a specific definition for purposes of Sec. 199A. The *final* regs now state that:

> "**Code §1222(11)** defines net capital gain as the excess of net long-term capital gain for the taxable year over the net short-term capital loss for such year. **Code §1(h)(11)** provides that for purposes of **Code §1(h)**, net capital gain means net capital gain (determined without regard to **Code §1(h)(11)**) increased by "qualified dividend income." Accordingly, **Reg. §1.199A-1(b)(3)** defines 'net capital gain' for purposes of **Code §199A** as net capital gain within the meaning of **Code §1222(11)** plus any 'qualified dividend income' (as defined in **Code §1(h)(11)(B)**) for the taxable year."

> **Comment:** This definition in the *final* regs, however, leaves out a specific mention of both Sec. 1231 gains and unrecaptured Sec. 1250 gain (which is taxed at a marginal rate of no more than 25%). Nevertheless, since these are treated on the **Form 8949** worksheet for **Schedule D** purposes as additional LTCG, they would be included in the definition of "net capital gain" for purposes of Sec. 199A.

> **Comment:** What is *not* mention in the final regs as an additional source of "net capital gain" are "collectibles" (which are taxed at a special rate of 28%). But, since they already receive a special marginal tax rate, the intent of Sec. 199A has been *not* to give an additional 20% deduction on top of any income that receives a preferential rate. So, arguably, gain from the sale or exchange of "collectibles" (e.g., paintings, sculptures, gems, etc.) would also be included in the definition of "net capital gains."

> **Comment:** Under **Code §1(h)(2)**, "net capital gain" is reduced by the amount that the taxpayer takes into account as additional "investment income" under **Code §163(d)(4)(B)(iii)** (i.e., for purposes of deducting additional investment interest expense on **Form 4952**). **Nevertheless, this reduction does *not* change the definition of "net capital gain"** for purposes of **Code §1(h)**. Instead, it reduces the amount of gains that can be taxed at the maximum capital gains rates as a tradeoff for allowing a taxpayer to elect to deduct more investment interest under **Code §163(d)**. **As a result, capital gains and qualified dividends, even though treated as investment income on Form 4952, are still treated as "net capital gain" for purposes of determining the Code §199A deduction. (Code §199A; Sec. 199A Deduction)**