# Tax Educators' Network, Inc.
# and
# ACE Seminars

## 2023 Federal Income Tax Update

## Comprehensive Manual
## for
## Business Entities
## and
## Individual Clients

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# <u>Prof. John J. Connors, JD, CPA, LLM</u>

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

## INDEX

# 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."

**Code §183 - Hobby Losses:**

☞**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.

> **Comment:** 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)**

> **Comment:** 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.

**Code §280E - Expenditures in Connection with Illegal Sale of Drugs**:

☞**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.**

**Background:** 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 **Code §280E**, 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. **(Code §280E; Medical Marijuana)**

> **Comment:** 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).

**Code §469 - Passive Loss Rules**:

☞**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. **(Code §469; Short-term Rentals)**

> **Comment:** 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. $31^{st}$).

**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.

**<u>Example</u>:** 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).

**<u>Comment</u>:** 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.

**<u>Comment</u>:** 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.

**<u>Definition of "nonqualified use</u>:"** 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.

**<u>Comment</u>:** 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.

**<u>Comment</u>:** 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).

**<u>Coordination With Recognition of Gain Attributable to Depreciation</u>**: 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)**) **(<u>Code §121</u>; Home Sale Exclusion)**

> **<u>Comment</u>:** 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.

## <u>Code §162 - Trade or Business Expenses</u>:

### ☞<u>"12-Month Rule" to Garner Additional Tax Deductions</u>

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 **<u>Reg. §1.263(a)-4(f)</u>** 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*).

**<u>Comment</u>:** 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).

**<u>Comment</u>:** 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.

## **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

**<u>Example</u>: "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).

**<u>Comment</u>:** 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).

**<u>Comment</u>:** 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

**<u>Example</u>: "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

**<u>Comment</u>:** 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).

☞**Defaulting on Retirement Plan Loans Can Result in Taxable Distribution**

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)**

> **Comment:** Retirement plan loans continue to be a high-priority item for IRS auditors, especially where a **Form 1099-R** 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.

☞**Retirement Funds Not Always Exempt from Creditors in Bankruptcy (*Lerbakken*, No. 18-6018, Bankruptcy App. Panel (8th Cir., 10/16/2018))**

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)**

> **Comment:** 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. **(*Seeley*, No. 16-cv-10935-ADB (DC, MA; 11/8/18))**

**Code §61 - Gross Income:**

☞**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**. **(Code §401; 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)**

☞**"Early Withdrawal Penalty" in Reality Constitutes a Tax (*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)**

☞**Exception to 10% Early Withdrawal Penalty to Pay Medical Expenses (*Salter*, TC Memo. 2022-29 (4/5/2022))**

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. **(Code §72(t); Early Withdrawal Penalty)**

> **Comment:** 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)**

> **Comment:** 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.

**<u>2019 Final Regs</u>:** 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.

☞**<u>Summary of Current Rules for RMDs</u>**
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.

**<u>Taxpayers Still Working</u>:** 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.

> **<u>Comment</u>:** 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.

> **<u>Comment</u>:** 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 $10^{th}$ 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. **(<u>Code §72(t)</u>; 10% Early Withdrawal Penalty)**

> **<u>Comment</u>:** "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."

**<u>Notice 2022-6</u>:** 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:**

# <u>TCJA CHANGES/DEVELOPMENTS</u>

## <u>INDIVIDUAL TAXATION</u>:

☞**<u>Comprehensive Analysis of Eliminated "2% Miscellaneous Deductions"</u>**

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.

> **<u>Comment</u>:** 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

> **<u>Comment</u>:** 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).

> **<u>Comment</u>:** Unreimbursed employee expenses cannot be deducted on **<u>Form 2106</u>** 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 **<u>Form 2106</u>** is still used to claim such expenses, the deduction is now shown on **<u>Schedule 1</u>, Line 11** as a "for-AGI" subtraction (i.e., instead of as a "2% miscellaneous deduction" which has now been eliminated on **<u>Schedule A</u>**).

**- 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.

> **<u>Comment</u>:** This is in spite of the fact that the **<u>Instructions</u>** 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).

<u>**Background**</u>**: 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)**)

<u>**Comment**</u>**:** 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.

<u>**New FAQs**</u>**:** 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.

**<u>Example</u> #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.

**<u>Comment</u>:** 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.

**<u>Comment</u>:** 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."

**<u>Example #1 (Cont'd.)</u>: "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 **<u>Code §469</u>** 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.**

**<u>Comment</u>:** 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.**

**<u>Example #1 (Cont'd.)</u>: "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.

**<u>Example #2</u>: "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**.

**<u>Example #2 (cont'd.)</u>:** 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.

**<u>Comment</u>:** 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).

**<u>Example #3</u>: "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**.

**<u>Comment</u>:** 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)**