Tax Educators' Network, Inc.
and
ACE Seminars

2023 Mid-Year Tax Update

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

His professional background includes over 48 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 **Sid Kess Award for Excellence in Continuing Education** by the American Institute of CPAs. 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.

2023 Mid-Year Tax Update

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

GENERAL LEGISLATIVE MATTERS:

Miscellaneous:

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

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

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

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

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

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

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

> **Comment:** After applying the first three restrictions for taking a K-1 loss (i.e., basis, **Form 6198** at-risk limitation, and **Code §469** passive loss rules), **Code §461(l)** (which was delayed from 1/1/2018 until the 2021 tax year) comes into play as a "fourth restriction." Essentially, an "excess business loss" is defined (for the 2022 tax year) as an otherwise allowable loss which is in $270,000 ($540,000 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 2022, those businesses with average gross receipts of $27 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.

☞**FAQs on Energy Efficient Home Improvements and Tax Credits (FS-2022-40)**

The IRS has issued frequently asked questions (FAQs) about energy efficient home improvements and residential clean energy property credits. The amended credits were part of the **Inflation Reduction Act** enacted on 8/16/22. These FAQs provide details on the IRA's changes to these tax credits, information on eligible expenditures, and provides examples of how the credit limitations work. **(Misc.; Energy Credits)**

Comment: Refer to separate highlighted handout on FS-2022-40

☞**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)**

☞**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.

- 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 current 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).

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.

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.

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.

- 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 a"djusted 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: 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 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.

☞**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)

☞**IRS to Issue Regs on Clean Vehicle Tax Credit (Notice 2023-01)**
Code §30D provides a tax credit for "qualified clean vehicles" that are acquired and placed in service by the taxpayer during the taxable year. The **Inflation Reduction Act** added certain requirements that any vehicle eligible for the new clean vehicle credit undergo "final assembly" in North America, and that no credit will be allowed for a vehicle with a manufacturer's suggested retail price more than an applicable limitation, depending on vehicle classification (i.e., $55,000 for passenger cars and $80,000 for SUVs and heavy vehicles). This IRS notice provides that the proposed regulations will include definitions of the following terms, which are relevant for new clean vehicles placed in service *after* December 31, 2022: (1) Final Assembly; (2) North America; (3) Manufacturer's suggested retail price; (4) Classifications for categories of vehicles, including vans, sport utility vehicles, pickup trucks, and other vehicles; and (5) Placed in service. **(Code §30D; EV Tax Credit)**

> **Comment:** Under this new guidance, the Treasury included a loophole that is supposedly in the law that would enable automakers to circumvent the above-mentioned restrictions imposed by **Code §30D** by allowing EVs leased to consumers to qualify as "commercial clean vehicles" (i.e., under **Code §45W**) which (1) need *not* be assembled in North America; (2) would *not* include the "material sourcing" requirement, or (3) income or price restrictions. For example, a BMW i7 (which has a retail price of $119,300) leased to a consumer would qualify for the "commercial clean vehicle" tax credit whether or not it is actually used by a business.

> **Comment:** The IRS has also released **FAQs** dealing with the clean vehicle tax credits for new, previously owned, commercial clean vehicles. There is also an IRS **website** which has a list of vehicles that may qualify for this credit in 2023. Buyers will need to use the vehicle identification numbers to confirm whether their vehicle qualifies for the 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).

☞**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 onward:

- 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 changes from 2021 to a 5 year amortizing asset deduction in 2022.

- The business interest expense deduction goes from 30% of EBITDA in 2021 to 30% of EBIT in 2022.

- The **Form 1099-K** reporting threshold of $20,000 for 2021 has been dropped to $600 for 2023 (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.

- 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:

☞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

- 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

- 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.

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 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.

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).

> **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).

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)**

☞**IRS Guidance on Digital Asset Reporting (Tax Tip 2023-45)**
All taxpayers filing 2022 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)**

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 §36B - Premium Tax Credit:

☞**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.

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?

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:

☞**IRS Issues Guidance on State Tax Assistance Payments (IR-2023-23)**

The Service has clarified the federal tax status involving special payments made by 21 states in 2022. It has determined that "in the interest of sound tax administration and other factors, taxpayers in many states will *not* need to report these payments on their 2022 tax returns."

For example, the IRS decided that it will *not* challenge the taxability of payments "related to general welfare and disaster relief." As a result, taxpayers in the following states do *not* need to report these state payments on their 2022 tax return: California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Maine, New Jersey, New Mexico, New York, Oregon, Pennsylvania and Rhode Island. Alaska is in this group as well, but their annual Permanent Fund Dividend remains taxable for federal purposes.

In addition, many people in Georgia, Massachusetts, South Carolina and Virginia also will *not* include state payments in income for federal tax purposes if they meet certain requirements. For these individuals, state payments will *not* be included for federal tax purposes if the payment is a refund of state taxes paid and either the recipient claimed the standard deduction or itemized their deductions but did *not* receive a tax benefit (i.e., under **Code §111**).

The IRS is aware of questions involving special tax refunds or payments made by certain states related to the pandemic and its associated consequences in 2022. A variety of state programs distributed these payments in 2022 and the rules surrounding their treatment for federal income tax purposes are complex. While in general payments made by states are includible in income for federal tax purposes, there are exceptions that would apply to many of the payments made by states in 2022.

Comment: To assist taxpayers who have received these payments file their returns in a timely fashion, the IRS is providing the additional information below.

Refund of State Taxes Paid: If the payment is a refund of state taxes paid and either the recipient claimed the standard deduction or "itemized their deductions but did *not* receive a tax benefit (for example, because the $10,000 tax deduction limit applied)," the payment is not included in income for federal tax purposes. Payments from the following states in 2022 fall in this category and will be excluded from income for federal tax purposes unless the recipient received a tax benefit in the year the taxes were deducted: Georgia, Massachusetts, South Carolina and Virginia.

Comment: The IRS referenced the **Code §111** "tax benefit rule" above and correctly (now, as opposed to their earlier guidance in **Rev. Rul. 2019-11**) stated that if the $10,000 SALT cap was exceeded, and especially if the taxpayer for instance met this cap solely with real estate taxes, for example, and therefore did *not* even list state income taxes on **Schedule A**, then any state income tax refund should *not* be taxable (i.e., the same result as if they had instead taken the standard deduction, or were otherwise subject to AMT).

General Welfare and Disaster Relief Payments: If a payment is made "for the promotion of the general welfare or as a disaster relief payment," for example related to the outgoing pandemic, it may be excludible from income for federal tax purposes under the **General Welfare Doctrine** or as a **Qualified Disaster Relief Payment**. Determining whether payments qualify for these exceptions "is a complex fact intensive inquiry that depends on a number of considerations."

The IRS has reviewed the types of payments made by various states in 2022 that may fall into the categories listed above and "given the complicated fact-specific nature of determining the treatment of these payments for federal tax purposes balanced against the need to provide certainty and clarity for individuals who are now attempting to file their federal income tax returns," the IRS has determined that "in the best interest of sound tax administration and given the fact that the pandemic emergency declaration is ending in May, 2023 making this an issue only for the 2022 tax year," if a taxpayer does *not* include the amount of one of these payments in its 2022 income for federal income tax purposes, the IRS will *not* challenge the treatment of the 2022 payment as excludible for income on an original or amended return.

Comment: What the IRS is also essentially saying is that it simply does *not* have the time or necessary resources to contest and audit these payments, especially in the light of the extensive delays that occurred with processing numerous returns over the last few years.

Payments from the following states fall in this category and the IRS will *not* challenge the treatment of these payments as excludible for federal income tax purposes in 2022: Alaska (Note: but only for the supplemental Energy Relief Payment which would have been received in addition to the annual Permanent Fund Dividend), California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Maine, New Jersey, New Mexico, New York, Oregon, Pennsylvania, and Rhode Island.

Comment: Illinois and New York issued multiple payments and in each case one of the payments was a refund of taxes, which should be treated as noted above (i.e., whether or not it provided a "tax benefit"), and one of the payments is in the category of a "disaster relief payment."

Other Payments: Other payments that may have been made by states are generally includible in income for federal income tax purposes. This includes the annual payment of Alaska's Permanent Fund Dividend and any payments from states provided as compensation to workers. **(Code §61; State COVID Payments)**

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)**

☞**Lawsuit Settlement Proceeds for Emotional Distress Not Excludible (*Tillman-Kelly*, TC Memo. 2022-111 (11/22/2022))**

The Tax Court confirmed that settlement proceeds which were intended to compensate for emotional distress had to be included in the plaintiff's gross income. The taxpayer in this instance claimed that his former employer

retaliated against him because he reported the misuse of funds. He then filed a lawsuit alleging that the employer's actions violated state whistle-blower protections. The parties settled, and he received $230,000 for emotional (as opposed to physical) distress. Nevertheless, he attempted to claim that the amount was excludible because his "emotional trauma arose from physical injuries that he got as a result of an altercation with his former boss." But neither the lawsuit nor the settlement language supported his position. **(Code §104(a); Personal Injury)**

Code §108 - Insolvency Exception:

☞**Lender Permitted to Collect on Debt Even after Issuing Form 1099-C to Defaulter (*Gericke v. Truist*, Civil No. 20-3053 (D.C., N.J., 3/26/2021))**

The district court held that a lender could still pursue the satisfaction of a judgment that it had previously received even though this occurred after it already issued a **Form 1099-C**. Initially, the parties in this case tried to settle the debt, but were unsuccessful. Eventually, the bank sent the couple a **Form 1099-C** reporting $200,000 of debt cancellation (COD) income. The couple then asserted that the bank's issuance of the **Form 1099-C** resulted in the debt being forgiven and the prior judgment voided. According to the court, though, the bank was required by IRS regulations to issue the **Form 1099-C**, and doing so did *not* result in the actual discharge of the couple's debt. **(Code §108; COD Income)**

Code §162 - Trade or Business Expenses:

☞**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)**)

☞**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)**

Code §163 - Interest Expense:

☞**Reg. 1.163-10T Election No Longer Necessary**

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:

☞**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?

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)**

Code §165 - Losses:

☞**IRS Insists on No Deduction for Cryptocurrency's Decline in Value (CCA 202302011)**
According to this IRS Chief Counsel Advice, a taxpayer whose cryptocurrency had substantially declined in value was *not* allowed a deductible loss for tax purposes due to the "worthlessness or abandonment" of the cryptocurrency. The taxpayer purchased units of cryptocurrency in 2022 for $1 per unit as a personal investment. During 2022, the value of the purchased cryptocurrency decreased until it was worth less than $.01 per unit. The taxpayer then attempted to claim a loss on their 2022 tax return taking the position that the investment was either worthless or abandoned (i.e., under **Code §165**). **Code §165** does allow for a deduction for "worthless securities." However, cryptocurrency is *not* listed as a "security" under **Code §165**. In addition, the cryptocurrency could *not* be considered "worthless" because it continued to be traded on more than one cryptocurrency exchange and still had value (i.e., no matter how small). **(Code §165; Cryptocurrency Losses)**

> **Comment:** See discussion below where an argument was made that under the "Madoff exception" and relying on **Rev. Rul. 2009-09** and **Rev. Proc. 2009-20** that an ordinary loss might be available for cryptocurrency investments if a "theft or embezzlement" situation was involved. But, if instead one was simply arguing that their cryptocurrency investment had become "worthless," then the IRS Chief Counsel Office position would be that there are technically no "securities" involved with such investments and that this would therefore negate such a write-off under **Code §165**.

☞**Potential Ordinary Loss Treatment for Crypto Transactions**
Rev. Rul. 2009-09 provides guidance for the income tax treatment of the losses, while **Rev. Proc. 2009-20** provides a "safe harbor" for how to compute and when to deduct these losses.

> **Comment:** Probing criminal cases involving digital assets is a priority for the IRS. Its Criminal Investigation division created the Office of Cyber and Forensic Services to group CID's digital assets, cybercrimes, and digital and physical forensics units. CFS is aiding with criminal probes across the IRS entailing the illicit use of digital assets, and how they are used or can be used to exploit the U.S. tax and financial systems.

> **Comment:** The IRS's Criminal Investigation division pursued fewer overall cases this year. It started the year with 2,558 cases, compared to 2,581 in 2021. It normally prosecutes 70% to 75% of its investigations each year and has a successful conviction rate of 90% or more. But some areas received more scrutiny in 2022. In addition to cybercrimes, they include abusive tax schemes, Bank Secrecy Act violations, high-income nonfilers, employment tax fraud, and corrupt preparers claiming inflated write-offs and credits. And, as with the rest of the IRS, CID is on a campaign to hire even more agents.

Rev. Rul. 2009-09: The ruling states that an investor is entitled to a theft loss, which is *not* a capital loss. In other words, a theft loss from a Ponzi-type investment scheme is *not* subject to the normal limits on losses from investments, which typically limit capital loss deductions to $3,000 per year when it exceeds capital gains from investments. The ruling clarifies that "investment" theft losses are *not* subject to limitations that are applicable to "personal" casualty and theft losses. The loss is deductible as an itemized deduction (i.e., so taxpayers claiming the standard deduction are out of luck), but is *not* subject to the 10 percent of AGI threshold or the $100 reduction that applies to many casualty and theft loss deductions. Essentially, it is *not* a "casualty loss itemized deduction" (currently *not* allowed under the **TCJA**), but instead is treated as a regular miscellaneous itemized deduction allowed in a similar manner as gambling losses (i.e., *not* subject to a 2% of AGI threshold).

The theft loss is deductible in the year the fraud is discovered, except to the extent there is a claim "with a reasonable prospect of recovery." Determining the year of discovery and applying the "reasonable prospect of recovery" test to any particular theft is highly fact-intensive and can be the source of controversy. But the revenue

procedure accompanying this revenue ruling provides a "safe-harbor approach" that the IRS will accept for reporting Ponzi-type theft losses.

The amount of the theft loss includes the investor's "unrecovered investment" (including income as reported in past years). As a result, the investor generally can claim a theft loss deduction *not* only for the net amount invested, but also for the so-called "fictitious income" that the promoter of the scheme credited to the investor's account and on which the investor reported as income on their tax returns for years prior to discovery of the theft.

Rev. Proc. 2009-20: The revenue procedure provides two simplifying assumptions (i.e., safe harbors) that taxpayers may use to report their losses as follows:

- Deemed theft loss: Although the law does *not* require a criminal conviction of the promoter to establish a theft loss, it often is difficult to determine how extensive the evidence of theft must be to justify a claimed theft loss. The revenue procedure provides that the IRS will deem the loss to be the result of theft if: (1) the promoter was charged under state or federal law with the commission of fraud, embezzlement or a similar crime that would meet the definition of theft; or (2) the promoter was the subject of a state or federal criminal complaint alleging the commission of such a crime, and (3) either there was some evidence of an admission of guilt by the promoter or a trustee was appointed to freeze the assets of the scheme.

- Safe harbor prospect of recovery: Once theft is discovered, it often is difficult to establish the investor's "prospect of recovery." Prospect of recovery is important because it serves to limit the amount of the investor's theft loss deduction. Prospect of recovery is difficult to determine, particularly where litigation against the promoter and other potentially liable third parties extends into future taxable years. However, this revenue procedure generally permits taxpayers to deduct in the year of discovery 95% of their net investment *less* the amount of any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance, such as that provided by the Securities Investor Protection Corporation (SIPC). A special rule applies to investors who are suing persons other than the promoter. These investors compute their deduction by substituting "75 percent" for "95 percent" in the formula above. **(Code §165; Crypto Losses)**

Comment: Arguably, investors in FTX and its related entities, as a result of the Federal indictment of the FTX founder, will qualify for a 2022 itemized deduction of 95% of their basis if all of the above requirements are satisfied.

☞**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. 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 "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 "Qualified PDDA Personal Casualty Losses" While Taking Standard Deduction & Related Special Tax Breaks for Casualty Situations**

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

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: Individuals can deduct personal "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 New 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.

Code §170 - Charitable Contributions:

☞**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.

☞**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?

☞**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.

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 made 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.

Even though 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** (or, up to $300 or $600 as an additional standard deduction for 2021).

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)**

☞**Charitable Contributions Made Directly from IRA**

Individuals age 70½ (or, 72 after 2019) who are now in a position that they must be taking "required minimum distributions" (RMDs) each year are allowed to satisfy this rule by donating such funds directly from their IRA to a qualified charity.

Comment: In the case of a joint return, each spouse has this option for a total of $200,000 ($100,000 each) annually.

Comment: The taxpayer must be age 70½ or older and in the position of have to make RMDs annually (which is now set to age 72 starting in 2020). So, for instance, an older taxpayer that is still working past that age (and, who is *not* a > 5% owner of the company) would *not* be able to take advantage of this strategy when otherwise making charitable donations (by rolling over some qualified plan monies into their IRA and make the QCD). Likewise, a taxpayer who has *not* yet reached age 70½, but who is required to take minimum distributions from an inherited IRA, for example over their remaining life expectancy, would also *not* be eligible.

This planning strategy avoids having the RMD included in the AGI of the IRA owner, while no charitable contribution deduction is permitted, even if the taxpayer is otherwise itemizing their deductions on Schedule A.

Comment: And, if the taxpayer is *not* itemizing their deductions, this contribution in no way diminishes the standard deduction that they are otherwise entitled to.

Comment: If the taxpayer is going to make certain charitable contributions anyway, *not* having the RMD included in AGI can have an impact on lessening the taxation of other income such as SSBs, or increasing the availability of other tax breaks and deductions which are based on one's level of AGI (or, taxable income as is the case with the Sec. 199A deduction).

When filling out **Form 1040**, you would still include the *total* amount of any distributions (including the funds going directly from the IRA to the charity) on **Line 4a** while subtracting any transfer to the charity when reporting the net amount of the IRA distribution on **Line 4b**.

Comment: The acronym "QCD" should be listed next to **Line 4b** so that the IRS will be alerted as to why the numbers do *not* match.

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 2020?

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.

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.

- 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)**

Code §172 - Net Operating 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 Updated 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.

☞**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 §199A - Qualified Business Income Deduction:

☞**Are Marijuana Business Profits Eligible for Sec. 199A Deduction?**
Can the owners of a marijuana business claim the Sec. 199A 20% deduction for K-1 income? At a recent ABA tax section meeting Luke Ortner of the **IRS Office of Chief Counsel (Small Business/Self-Employed)** confirmed that result. But he also explained that when calculating the factors for determining whether a taxpayer is eligible for the deduction, **Code §280E** still comes into play. **Code §280E** denies deductions or credits for the business expenses of any trade or business that traffics in controlled substances, including state-legal cannabis businesses, other than for the cost of goods sold. But given that this endeavor constitutes a "trade or business," **Code §199A**, enacted by the **Tax Cuts and Jobs Act**, provides for a deduction of up to 20 percent of passthrough income for qualified business owners. **(Code §199A; Sec. 199A Deduction)**

Comment: The denial of all business expenses except COGS brings into play an interesting question. Namely, any "qualified business income" (QBI) from such businesses will correspondingly be higher given that all other types of trade or business expenses are denied under **Code §280E**.

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)**

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)**

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.

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:

☞**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)**

☞**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.

☞**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 is proposing to now 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.

☞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)**

☞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 §529 - Qualified Tuition Programs:

☞**Redepositing College Refunds Back into Sec. 529 Account**
You should be aware of a special IRS waiver if you used 529 funds for your child's college education and you have now gotten a refund from the school for canceled classes or housing as a result of the school's closing its physical campus because of coronavirus concerns. Tax legislation enacted in 2015 waives tax and penalties if, after a distribution is made from the account, the student gets a refund from the college or university. But to qualify for relief, you generally must redeposit the funds into a 529 account for the same beneficiary *within 60 days*. The re-contribution is treated as principal in the account. **(Code §529; 529 Plans)**

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 mush 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:

☞**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 §6015 - Innocent Spouse Relief:

Ex-spouse in Poor Health Granted Innocent Spouse Relief (*Parker*, TC Memo. 2022-110 (11/15/2022))

The Tax Court agreed that an ex-spouse with serious health issues qualified for equitable relief for back taxes. The couple who divorced in 2018 mistakenly omitted income from their 2016 return. After the IRS pursued them for the unpaid taxes, the ex-husband requested relief as an innocent spouse. He was in poor health, however, unable to work with his only income coming from Social Security disability payments. Based on these and other factors, the Tax Court granted him equitable relief. **(Code §6015(f); Innocent Spouse)**

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)**

Notes:

PARTNERSHIP/LLC TAXATION:

Miscellaneous:

☞**Service Pledges More Audits of Flowthrough Entities**

There is no question that audits of partnership entities by the IRS have been deplorable in recent years. Currently, the Service audits less than 2 partnership returns out of every 1,000 Form 1065s filed (i.e., less than 0.2%). Even then, about 50% of exams result in no change to taxes at the partner level. As a result, the IRS has pledge to improve these figures and bring in additional tax revenues by dramatically increasing its enforcement efforts.

The Service has announced that it will be hiring more revenue agents, tax law specialists and attorneys with experience in pass-through entity taxation to work on audits involving large partnerships and LLCs. It has also made changes to the **Form 1065** and is updating its models for selecting partnership returns to audit. Targeted compliance campaigns will focus on some of the more complex issues relating to partnerships and their owners. One of the key issues that IRS auditors will take an in-dept look at involve large losses claimed by partners on their 1040s.

> **Comment:** Right now, **Form 7203** is required as an attachment to Schedule E, page 2 whenever an S corporation share hold claims a K-1 loss, receives a distribution, disposes of their stock or receives a repayment of a loan made to the S corporation. Nevertheless, there is currently no similar form for partners.

The Service is concerned that partners claiming flow-through K-1 losses from partnerships on their individual returns might *not* have sufficient adjusted basis in their partnership interests to do so (or, the at-risk and passive loss rules have not been properly taken into account). Another key issue is whether partners who sell their partnership interests are properly determining not only the amount of the gain or loss, but also the character of such gain or loss (i.e., pursuant to **Code §741** and **751**.

Centralized Audit Regime: The IRS was hoping that its new "centralized partnership audit regime" would result in a significant increase in the audit of more partnerships, as well as making it easier to collect any additional taxes owed. Many larger partnerships have multiple levels of ownership, with hundreds or thousands of partners. Previously, when the Revenue Service examined one of these huge partnerships and proposed changes, it had to track down each and every partner and make the adjustments to their respective returns. That required more personnel and resources than the agency otherwise had available.

This new regime applies to partnership returns filed for tax years beginning after 2017 and allows the IRS to audit the partnership's tax return and collect any tax due solely from the partnership entity and not each individual partner. The partnership can then elect to push out the tax to the partners on record for the audited tax year by issuing adjusted **Forms K-1** to them with the partners then taking the changes into account on their own tax returns.

Partnerships with 100 or fewer partners can elect out of these centralized audit rules (unless a trust is one of the partners). **IRS Pub. 5388** for a one-page road map on the process, time frames and other pertinent information. Nevertheless, this new audit program has failed to make a dent in IRS's "no-change rate." As a matter of fact, it is even worse now. In 2019, the IRS began auditing selected 2018 **Form 1065s** under the new regime and closed 78% of those exams with no change to taxes, Treasury inspectors stated in a recent report. The Service agrees with the GAO that the no-change rate is too high, but it continues to insist that "it is too early to reach any definite conclusion about that finding." **(Misc.; IRS Audits)**

☞**IRS Releases Domestic Filing Exception to Schedules K-2 and K-3**

The IRS is offering a *new* "filing exception for purely domestic partnerships" in the draft version of the **2022 Partnership Instructions** for **Schedules K-2 and K-3 (Form 1065)**. A "domestic partnership" (as defined under **Code §7701(a)(2)** and **(4)**) will *not* need to complete and file with the IRS the **Schedules K-2** and **K-3** or furnish to a partner the **Schedule K-3** [except where requested by a partner at least one month before the due date (without extension) of **Form 1065** (i.e., the "one-month date") if each of the following four criteria are met with

respect to the partnership's tax year 2022: (1) No or limited foreign activity, (2) Only U.S. citizen/resident alien partners, (3) Partner notification, and (4) No 2022 **Schedule K-3** requests by the one-month date.

Comment: Further guidance and examples concerning the need for reporting by partnerships with domestic activity and with partners who are U.S. persons are available on the IRS **website**.

Form 1116: Individuals with sources of foreign income (or, who have otherwise paid foreign taxes directly, or through a flowthrough entity) are usually required to file **Form 1116** in order to claim the foreign tax credit on their personal tax return.

Schedules K-2 and K-3: When a partnership or S corporation has foreign sourced income, expenses, assets or tax the entity is required to fill out the 19-page **Schedule K-2** for the entity with each owner receiving the 20-page **Schedule K-3** reflecting their respective share of the entity's foreign activity items.

Waiver for 2021 Tax Year: For the 2021 tax year the IRS waived the filing requirement in **Notice 2021-39** for most "small partnership and S corporations" if the entity met a few basic requirements. A similar waiver is also applicable to returns filed for the 2022 tax year (i.e., "**Form 1116 Exemption**" discussed more fully below). Nevertheless, the penalty for failure to file these schedules was $280 for each **K-2** or **K-3** *not* filed where otherwise required, or where they were incorrect or incomplete.

Payments to Foreign Related Parties of Domestic Partnerships: Even with a partnership with no foreign source income, no assets generating foreign source income, no foreign partners, and no foreign taxes paid or accrued may still need to report information on **Schedules K-2** and **K-3**. For example, if the partner claims a credit for foreign taxes paid or accrued by that partner, the partner may need certain information from the partnership to complete **Form 1116** or **1118**. In addition, a partnership that has only domestic partners may still be required to complete **Part IX** when the partnership makes certain deductible payments to foreign related parties of its domestic partners.

New Waiver for 2022 Tax Year: These new draft instructions waive the requirement for a partnership to file **Schedule K-2** and furnish partners with a copy of **Schedule K-3** if it is a domestic partnership and otherwise meets the following four rules:

1. The partnership has no foreign activity, or only passive foreign income (e.g., dividends or interest) that has less than $300 of foreign tax paid or withheld thereon and which is otherwise reported to the entity;

2. All 2022 owners are US citizens/US estates/US grantor trusts/regular trusts with only US citizen beneficiaries, or resident aliens;

3. The partnership notifies it partners by 1/15/23 (electronically or via mail, which is two months before the due date without extension) that no **Schedule K-3** will be prepared unless the partner notifies the entity of the need for the K-3; and

4. The partnership does *not* receive a notification from any partner of their need for a **Schedule K-3** by 2/15/23 (i.e., one month before the unextended due date of the entity's tax return).

Comment: Keep in mind that that any partnership with an S Corporation, C Corporation or another partnership owner does *not* meet this "domestic filing exemption" but might still satisfy the "**Form 1116 exemption**" discussed below.

Late Schedule K-3 Requests: If a partnership receives a request from a partner for the **Schedule K-3** information *after* the "1-month date deadline" (i.e., after 2/15/23) and has *not* received a request from any other partner for **Schedule K-3** information on or before 2/15/23 (i.e., the 1-month date), the "domestic filing exception" is deemed as being satisfied. As a result, the partnership is *not* required to file the **Schedules K-2** and **K-3** with the IRS or furnish the **Schedule K-3** to any of the *non-requesting* partners. However, the partnership is still

required to provide the **Schedule K-3**, completed with the requested information, to the *requesting* partner on the *later* of the date on which the partnership actually files the **Form 1065** or one month from the date on which the partnership originally received the request from the partner.

Form 1116 FTC Exemption: If a partnership does *not* meet the "domestic filing exception," it may still meet the **Form 1116 Exemption** to filing the **Schedules K-2** and **K-3**. In other words, if the partnership has no direct or indirect partner that would be able to claim a foreign tax credit (or, who is otherwise exempt from filing **Form 1116** or **1118**). This **Form 1116 exemption** applies in situations such as when foreign taxes are all on passive income *and* amount to less than $600 MFJ/$300 for others in total FTC amount being claimed. Nevertheless, the partnership would still need a statement (or, a **W-8** or **W-9**) from every partner in this type of situation no later than 2/15/2023 (i.e., one month before the unextended **Form 1065** due date) as was the case for the 2021 tax year. **(Misc.; Schedules K-2/K-3)**

☞**Revocable Trusts & Electing Out of Partnership Audit Rules**

The owners of the partnership are a S-Corp and a revocable trust in the name of the wife. The S-Corp is owned by a revocable trust in the husband's name. Does having a partner that is a "revocable trust" prevent the option to elect out of the partnership audit rules? Two recent articles discuss this issue.

According to a **Tax Advisor** article, "The IRS decided *not* to expand the definition of "eligible partner" to include persons or entities other than those in the statute even though it has received numerous comments requesting it to exercise its discretionary authority to do so. As a result, an "eligible partner" for purpose of electing out of the new partnership "centralized audit rules" does *not* include partnerships, trusts, disregarded entities, nominees, or other similar persons that hold an interest on behalf of another person, foreign entities that are *not* eligible foreign entities, and estates that are *not* estates of a deceased partner."

On the other hand, the **Kiplinger Tax Newsletter** states "Note that a partnership interest held 'in trust' is generally *not* eligible to elect out of the rules. While no direct statutory authority exists to evidence an exception for *revocable* trusts, they are typically viewed as 'disregarded entities' for tax purposes. We suspect that this would permit an election out for a partnership interest held in a revocable trust. However, we do *not* yet have a guidance from the IRS on this issue." **(Misc.; IRS Audits)**

> **Comment:** At this point, a good argument can be made that revocable trusts (that do *not* "spring into being" until the death of the grantor) are indeed "disregarded entities" for income tax purposes under **Code §671**. Therefore, an election should be allowed to opt out of these new partnership audit rules since the partnership (and, S corporation) interests in this case are deemed owned by the respective husband and wife grantors for income tax purposes of the Code.

Code §1(h) - Unrecaptured Sec. 1250 Gain:

☞**Unrecaptured §1250 Gain Treatment Avoided on Liquidating Distributions Made Out of Real Estate LLCs**

Consider a situation where a member of an LLC holding appreciated real estate decides to sell out their interest to an unrelated third party. To the extent that there is any gain due to straight-line depreciation, this will be considered "unrecaptured Sec. 1250 gain" which is taxed at no more than a 25% marginal tax rate. And, this gain, along with any other Sec. 1231 gain on the property, would flow from Form 4797 to Schedule D. Basically, the rule is that the normal capital gains treatment accorded by **Code §741** is negated by the "hot asset" rules of **Code §751**. Surprisingly, there is a different answer where this partner or LLC member has their interest terminated by receiving a liquidating distribution from the entity itself (i.e., similar to a stock redemption had this instead involved a corporation). **Reg.§1.1(h)-1(b)**, (which deals with the appropriate tax rates in various situations) indicates that the 25% rate does *not* come into play, as well as the **Code §751** "hot asset" rules *not* being imposed, where the interest is *redeemed* instead of being sold to an outside third party. As a result, the exiting partner receives Sec. 1231 treatment on the *entire* gain, and absent any Sec. 1231 losses for the current year (or prior 5 years that have *not* otherwise been recaptured), this entire gain would flow to Schedule D. **(Code §1(h); Unrecaptured Sec. 1250 Gain)**

Comment: With the commercial real estate market being depressed in some areas of the country, it might not be unusual to see LLC members wanting to perhaps cash out of their ownership interests. By having the entity refinance their real estate holdings and redeem this member's interest, they will be able to exit with capital gains treatment (which could be taxed at up to 23.8% vs. certain unrecaptured Sec. 1250 gain being taxed at up to 25%). Of course, the remaining members of the LLC would then be stuck with this exiting member's share of 25% gain when they sold their respective interests (or, just had the entity sell the property with the proceeds being passed out on the dissolution of the entity).

Code §162 - Trade or Business Expenses:

☞**Otherwise Reimbursable Expenses Not Deductible by Partner on Schedule E (*McLauchlan v. Commr.*, 113 AFTR 2d 2014-XXXX (5th Cir., 3/6/2014))**

The 5th Circuit confirmed that a law firm partner should *not* be permitted to deduct business expenses that were otherwise reimbursable by the firm. The partnership agreement specifically stated that expenses incurred for "business meals, automobiles, travel and entertainment, conventions, continuing legal education seminars and professional organizations" would be borne by the partner unless reimbursement was approved by the managing partner. Additional expenses that taxpayer "chose to incur," such as for advertising, home office, or supplies, were *not* deductible as "partnership expenses." Because all of the claimed expenses in this instance were potentially reimbursable by the partnership, or were *not* partnership expenses that taxpayer was required to incur, the 5th Circuit *affirmed* the Tax Court's disallowance. To conclude otherwise "would allow a taxpayer to convert an expense of the partnership into one of his own simply by failing to seek reimbursement." **(Code §162; Partnership Expenses)**

Code §163 - Investment Interest Expense:

☞**Inherited Partnership Interests Not Subject to Investment Interest Limit (*Lipnick*, 153 TC No. 1 (8/28/2019))**

The taxpayer acquired interests in four partnerships by gift or bequest from his father. Prior to the transfers, the father received debt-financed distributions from the partnerships. After receiving the interests, the taxpayer treated his distributive shares of partnership interest expense as fully deductible against his allocations of partnership income. The IRS argued that the taxpayer should have "stepped into the shoes" of his father and reported the expense on **Form 4952** as "investment interest" subject to the **Code §163(d)** limit. The Tax Court disagreed, holding that the taxpayer made a "debt-financed acquisition of the partnership interests" (i.e., governed by IRS **Notice 89-35**) he received from his father. Because the taxpayer did *not* actually receive the proceeds of the partnerships' debts, interest expense passed through to him was *not* "investment interest" under **Code §163(d)**

Background - Investment Interest: In the case of a taxpayer other than a corporation, the amount allowed as a deduction for investment interest for any taxable year cannot exceed the "net investment income" (i.e., for **Form 4952** purposes as opposed to NIIT which is used for **Form 8960** purposes with the 3.8% Medicare surtax) of the taxpayer for the taxable year. (**Code §163(d)(1)**). "Investment interest" is defined as interest that is "paid or accrued on indebtedness properly allocable to property held for investment." (**Code §163(d)(3)(A)**)

Background - Interest Expense "Tracing Rules:" Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. (**Reg. §1.163-8T(a)(3)**) For example, if a taxpayer uses debt proceeds to make a personal expenditure, such as taking a vacation, the interest is treated as nondeductible personal interest. (**Reg. §1.163-8T(a)(4)(ii), Example (1)**)

These regs, however, do *not* specify how these tracing rules apply to partnerships and their partners. But the IRS has published guidance in **Notice 89-35**. That Notice states that, if a partnership uses debt proceeds to fund a distribution to partners (i.e., to make debt-financed distributions), it is each partner's actual use of the proceeds to determine whether the interest passed through to them constitutes investment interest. As a result, if a partner uses the proceeds of a debt-financed distribution to acquire property that he holds for investment, the corresponding interest expense incurred by the partnership and passed on to them will be treated as investment

interest.

On the other hand, **Reg. §1.163-8T(c)(3)(ii)** explains how debt should be allocated where *no proceeds are actually disbursed* to the taxpayer. It states that if a taxpayer incurs or assumes a debt in consideration for the sale or use of property or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property.

Notice 89-35 in **Part IV.** refers to the scenario described in **Reg. §1.163-8T(c)(3)(ii)** as a "debt-financed acquisition," as opposed to a "debt-financed distribution," and it explains how the reg applies to partnerships and their partners: "In the case of debt proceeds allocated under **Reg. §1.163-8T** to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method."

Facts: The taxpayer's father had owned interests in partnerships that made "debt-financed distributions" to the partners and he had used the proceeds of those distributions to purchase assets that he held for investment. As a result, he treated the interest paid by the partnerships on those debts and passed through to him as "investment interest" (i.e., on **Form 4952**) subject to the limitation on deductibility imposed by **Code §163(d)**. But, the taxpayer in this instance who inherited (or, was gifted) these partnership interests was *not* personally liable for any of the partnership loans. And, the partnerships continued to incur interest expense on the debts, which was passed through to the taxpayer as a *new* partner which he treated as allocable to the partnerships' real estate assets and reported the interest expense (i.e., on **Schedule E, page 2**) as regular business interest that offset the passed-through partnership real estate income.

Tax Court Decision: The Court characterized the IRS's argument as essentially being that the taxpayer "stepped into his father's shoes," with the result that the interest should be reported as "investment interest," and would remained as such so long as the loans remain on the partnerships' books. The Court, however, found that there was no support for this theory in the statute, the regs, or the decided cases, especially since the taxpayer *did not receive, directly or indirectly, any portion of the debt-financed distributions* that the partnerships made to his father. Nor did the taxpayer use distributions from those partnerships to make investment expenditures.

Instead, the Court concluded that, whereas the father received a "debt-financed distribution," his son (i.e., the taxpayer in this case) should be treated as having made a "debt-financed acquisition" of the partnership interests he acquired from his father by way of gift or inheritance. Therefore, for **Code §163(d)** purposes, the debt proceeds should be allocated among all of the partnerships' real estate assets using a reasonable method, and the interest paid on the debt is allocated to those assets in the same way. (**Reg. §1.163-8T(c)(1)**) In this instance, the partnerships' real estate assets were actively managed operating assets. Even the IRS agreed that those assets did *not* constitute "property held for investment."

The IRS countered that under **Reg. §1.163-8T(c)(3)(ii)**, the taxpayer, when acquiring the partnership interests from his father, did *not* "assume a debt" or "take property subject to a debt." Instead, these loans "were bona fide liabilities of the partnerships." As a result, the taxpayer had no personal liability on those loans, which were nonrecourse, and that the liens held by the lenders ran against the partnerships' real estate assets, *not* against the taxpayer's partnership interests.

The Court disagreed stating that the taxpayer acquired his interests in the partnerships subject to the partnership debts, even though he did *not* personally assume those debts, which remained nonrecourse with respect to the partners individually. In the converse situation, where a partner sells a partnership interest, the regs provide that the partner's "amount realized" includes his share of the partnership liabilities of which he is relieved, even if the liabilities are nonrecourse. (**Reg. §1.752-1, Reg. §1.1001-2(a)(4)(v)**) For purposes of subchapter K partnership rules generally, any increase or decrease in a partner's share of partnership liabilities is treated as a deemed contribution or distribution, regardless of whether the debt is recourse or nonrecourse. (**Code §752; Reg. §1.752-1**). And, the fact that a partner is *not* personally liable for a partnership's debt does *not* mean that his partnership interest is *not* "subject to a debt" for purposes of Subchapter K. The Court then concluded that **Reg.**

§1.163-8T(c)(3)(ii), in conjunction with **Notice 89-35**, dictates that the interest expense passed through to the taxpayer from the partnerships was *not* "investment interest" under **Code §163(d)**. **(Code §163; Investment Interest)**

Code §702 - Partner's Distributive Share:

☞**Partner Taxed on Distributive Share Regardless of Being Constructively Received (*Dodd*, TC Memo 2021-118 (10/5/2021))**

The Tax Court agreed with the IRS that a partner was liable for tax on her distributive share of income from the partnership, regardless of whether she constructively received that allocable share of income or not.

Background: Code §702(a) provides that, "[i]n determining his income tax, each partner shall take into account separately his distributive share" of the partnership's items of income and loss. Specifically, each partner must include their distributive share of the partnership's "gains and losses from sales or exchanges of property described in section 1231." (**Code §702(a)(3)**) This rule applies regardless of whether the partner receives the income currently, via distribution or otherwise. (***Basye*, 31 410 U.S. 441 (S Ct, 12/271973)**)

Facts: In 2013, a partnership in which the taxpayer was a partner sold a building. The partnership then sent her a K-1 allocating $1 million as a net section 1231 gain for the year. Also in 2013, the partnership paid back a loan it had taken out in 2011 (i.e., repayment of principal on a loan does *not* give rise to a tax deduction). The taxpayer was a co-borrower on the loan. The amount of the share of Dodd's loan liability that was paid back was more than $1 million. The taxpayer did *not* pay income tax on the 1231 gain, arguing that she never received the money because it was used to pay back the loan. In other words, she did *not* constructively receive the funds under **Reg §1.451-2**.

Tax Court Decision: The Tax Court disagreed with the taxpayer and concluded that for Federal tax purposes the question is *not* whether she constructively received the funds. Under **Code §702(a)**, the Court agreed that she is taxable on her distributive share of the section 1231 gain whether or not it was actually distributed. **(Code §702; Distributive Share)**

> **Comment:** Here, the monies derived from the sale of the real estate were used to make a distribution to the majority partner (i.e., who controlled the "purse strings" of the entity). So, the taxpayer here had to pay tax on the $1 million Sec. 1231 gain allocated to her despite not have any cashflow from the partnership to do so. The "moral of the story" is that if you are going to be a minority owner in a flowthrough entity (i.e., S corp or partnership/LLC), make sure that there is a written clause in your ownership agreement that distributions sufficient to pay all federal, state and local taxes will be made each year to you.

Code §704 - Partner's Basis in Capital Account:

☞**New IRS Audit Effort Focuses on Partnership Loss Limitation Rules**

The IRS Large Business and International (LB&I) Division recently announced that it has added a new "**compliance campaign**" which addresses the tax basis limitations that apply to the amount of partnership losses (or, deductions such as Sec. 179 immediate expensing) that can be claimed by its partners. The **Code §704(d)** limitations which "are the main focus of this campaign" state that a partner's distributive share of partnership loss will be allowed only to the extent of the partner's adjusted basis in his partnership interest at the end of the partnership year in which the loss occurred. If the partner's share of losses exceeds this amount, the excess amount is suspended and may be carried over for use in another tax year in which the partner has basis available. The IRS has said that "partnership compliance is a priority and that the agency is stepping up enforcement." **(Code §704; K-1 Losses)**

> **Comment:** Starting with the 2022 tax year, there are basically four distinct barriers to taking a flowthrough loss from a partnership return. They are applied in the following order: (1) Adjusted basis of the partner's

interest; (2) How much of that adjusted basis is considered to be at-risk (i.e., pursuant to **Code §465** as shown on **Form 6198**); (3) Is the loss (or, deduction such as Sec. 179 immediate expensing) subject to the passive loss (PAL) rules under **Code §469**, and (4) Does the loss represent an "excess business deduction" under **Code §461(l)** $250,000/500,000 limits. If a capital loss is being passed through on the K-1, then it might also be subject to the overall cap of $3,000 annually. And, any NOLs which might result due to a K-1 loss can only be carried forward starting in 2021 onward.

Comment: The S corporation equivalent of this increased focus by the IRS on properly claiming K-1 losses or deductions flowing through from a partnership, is the current requirement on page two of **Schedule E, Part II** where a separate "basis statement" (i.e., on **Form 7203**) needs to be provided if (1) a K-1 loss is being claimed; (2) the shareholder is receiving a distribution; (3) the shareholder is disposing of their stock; or (4) the shareholder is receiving a loan repayment from the S corporation. **(Code §704; Partnership Losses)**

☞**Recent Case Highlights Inappropriate Claiming of Partnership Losses (*Kohout*, TC Memo. 2022-37 (4/18/2022))**

An individual owned 1% of a partnership with the other 99% being owned by an S corporation, which was wholly owned by the same individual. The partnership incurred $132,000 in losses for the year, and this individual partner claimed that both he and the S corporation should be allowed to deduct their pro rata share of the partnership's losses. But because neither he nor the S corporation could prove their adjusted basis in their partnership interests, the Tax Court agreed with the IRS and disallowed the pass-through losses.

Partner's Adjusted Basis in Partnership Interest: Generally, under **Code §704(d)**, a partner is permitted to deduct their share of a partnership's loss for a taxable year only to the extent of the adjusted basis of their partnership interest calculated as of the end of the tax year. Under **Code §§705(a)(1)** and **722**, a partner's "outside basis" is *increased* in part by the partner's distributive share of income and the partner's contributions to the partnership. Meanwhile, under **Code §752(a)**, any increase in a partner's share of liabilities or assumption of partnership liabilities also increases the partner's outside basis. On the other hand, under **Code §§705(a)(2)** and **733**, a partner's basis is then *decreased* by the partner's distributive share of partnership losses, nondeductible expenses, and distributions.

Deducting K-1 Losses: If the partner cannot establish their adjusted basis in their partnership interest, then they are barred from currently deducting any partnership losses. (See **Code §704(d)**; ***Sennett v. Commr.*, 80 T.C. 825, 829–30 (1983), *aff'd*, 752 F.2d 428 (9th Cir., 1985)**. Furthermore, "proof of basis is a specific fact which the taxpayer has the burden of proving." (See ***O'Neill v. Commr.*, 271 F.2d 44, 50 (9th Cir. 1959), *aff'g* T.C. Memo. 1957-193**; see also ***Powers v. Commr.*, T.C. Memo. 2013-134**) **(Code §704(d); K-1 Losses)**

☞**Using Real Estate LLCs to Loan Monies to LLCs vs. S Corporations**

It is very common for businesses to keep the real estate off of the company's balance sheet in order to shield these valuable assets from creditor claims as well as possible litigation. And, the entity of choice is often the LLC to hold title to such properties. Now, considering the discussion above with regard to the effect of liabilities on an owner's basis, consider the following scenario where an LLC business is in need of funds for its day-to-day operations. Furthermore, assume that the LLC holding the real estate is owned by the *same* individuals and in the *same* percentages as the LLC which is operating the trade or business.

The owners proceed to refinance the real estate and cause the monies received to be immediately loaned directly to their business. In other words, the monies were *not* first distributed out of the real estate LLC to the individual owners (who would have sufficient basis given the increase caused by this new mortgage as "qualified real property indebtedness" in the first place) who would then loan them to the business. Nevertheless, each member of the LLC operating the business would still have an increase to their respective bases due to the overall increase in the LLC's liabilities.

Now, consider the same scenario with an S corporation which is in need of additional funds for operations. The shareholders also own an LLC in the same percentages as the corporation and decide to refinance the real estate

that it holds title to. The key here is that the monies **are lent directly from the real estate LLC to the S corporation**. Even if the LLC's debt mortgaged by the real estate is also **personally guaranteed** by the S corporation shareholders, they **will receive no step-up in basis** due to this new debt on the company's balance sheet (i.e., the loan that it now owes to the LLC). Instead, they should have first distributed the monies out of the LLC to themselves individually and then lent it to their S corporation as direct shareholder loan. Only in this way could the debt have increase their stock basis.

> **<u>Comment</u>:** It's a shame that even though the S shareholders might be personally called upon to repay this debt, they will receive no corresponding basis increase in their stock until such time that this might actually occur. Merely by recasting this loan as coming directly from themselves would a more preferable result occur.

☞Refinancing Real Estate Held by LLC to Ease Admission of New Members

It was not unusual to see significant appreciation in real estate assets during the period before 2008 (and, also a bit more recently, especially on the two U.S. coasts). And, if the real estate is held as tenants-in-common, it might be for new owners (e.g., family members) to come into the picture. However, if the real estate is instead held by a separate entity such as an LLC, the admission of new owners might be facilitated by first refinancing the property and encumbering it with more debt thereby driving down the net fair market of the property. As a result, the purchase price might be more affordable for these potential new owners. Also, the **debt might be personally guaranteed by just these original owners** so any new purchaser would *not* become liable for its repayment. Nevertheless, consider the illustration below where the distinction between an LLC vs. an S corporation incurring more debt might backfire from a tax standpoint.

> **Example 4: "Refinancing Real Estate Eases Admission of New LLC Members"**
>
> An LLC with three equal members owns a commercial building valued at $600,000. There is no debt on the property and the members each have a basis in their LLC interest equal to $80,000.
>
> Two additional individuals wish to buy into the LLC, but **cannot afford** the current admission price of $120,000 ($600,000 ÷ 5). Therefore, the LLC secures a mortgage in the form of a qualified nonrecourse debt on the property in the amount of $300,000. With the cash proceeds in hand, the LLC makes a current nonliquidating distribution of $100,000 to each of the original three members. The two new members are then able to purchase their LLC interests for just $60,000 (i.e., $300,000 FMV/5 LLC members).
>
> The outside bases of each of the original three members increased from their current levels of $80,000 (before the new mortgage was obtained) to $180,000.[1] When the cash distributions are made to the three members, their bases return to their original level of $80,000 each. With the admission of the two new members, the debt is then shared in five equal portions. This reduces the original basis of each of the original three members to $40,000 (The $300,000 mortgage initially shared three ways is now shared five ways.) This results in a basis reduction of $40,000 (i.e., $100,000 down to just $60,000) for each to the three original members.[2]
>
> For the original members, there is no tax effect when the decrease in the sharing of the liability (which is treated as a deemed cash distribution) caused by **Code §752(b)** occurs. This is because it lowers the bases of the three original members by $40,000. The original members have sufficient basis in their respective interests to absorb this decrease. Sharing the new liability allows the two new members to afford to buy a 20% interest in the LLC.

Each Original

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[1] IRC §752(a)

[2] IRC §752(b)

	Member's Basis
Beginning adjusted basis of capital interest	$ 80,000
Share of $300,000 mortgage	100,000
Cash distribution	(100,000)
Basis after admission of new partners	$ 80,000
Share of mortgage assumed by new partners	(40,000)
Basis after admission of new partners	$ 40,000

Comment: This example again illustrates one of the potential advantages of a partnership/LLC when it comes to the effect of liabilities on owner basis. In comparison, S corporation debt has no effect on a shareholder's basis unless it represents a direct loan from that particular shareholder to the entity (guarantees do *not* count until such time as that owner actually has to repay the debt of the entity). In **Example 4**, as an S corporation, refinancing the property for $300,000 and then making a distribution of $100,000 results in an immediate capital gain to each of the original owners equal to $20,000 ($80,000 basis – $100,000 distribution) since the debt does *not* serve to increase their respective bases, even if they are required to guarantee such debt (the lender requires this additional security along with the property serving as collateral).

☞**Special Allocations - Partnership K-1 Items**

Comment: Special allocations are preferable to guaranteed payments since the latter serve to reduce "qualified business income" that the entity might otherwise have.

The other two remaining requirements under the Code for special allocations would be that capital accounts were maintained and that, if there was a deficit in this particular partner's capital account, he would be required to make a sufficient contribution to restore that balance back up to zero before exiting the partnership (i.e., a "deficit restoration order" or DRO).

There are three specific requirements under **Code §704(b)(2)** for partnerships intending to make special allocations of K-1 items in a particular tax year. The most important one is that there be "substantial economic effect" for the allocation (as opposed to it only being done strictly for a more favorable tax result to a particular partner). In a client's situation where the banks had refused to lend any more monies to the business, and with the losses that it had incurred to-date, there was no source of funds to finance continued operations. Therefore, an individual partner decided to contribute (v. lend) an additional $250,000 to the entity which allowed the business to stay afloat, at least for the most current tax year when it incurred over $350,000 in losses.

A fair allocation in this instance, which should be committed to writing as an addendum to their partnership agreement (although, no special statement need to be included with either the Form 1065 or the partner's personal tax return), is that the first $250,000 of the current tax year loss (which was financed by his capital contribution) would be specifically allocated to his K-1, with the remainder of the $350,000 overall loss being allocated based on their respective ownership percentages. **(Code §704(b)(2); Special Allocations)**

Example: Consider a tax practice equally owned by two partners. In the year just ended, though, John who is nearing retirement spent an extraordinary time in FL honing his golf swing and lowering his handicap. Meanwhile, his partner back at the firm ended up putting in 75% of the overall chargeable hours for the year.

At their annual partner meeting, it was agree that despite their 50/50 ownership, John would only receive 25% of the bottom line profit, while 75% of the remaining profit would be specially allocated to the other partner. This was done instead of giving the other partner a set amount as a guaranteed payment to compensate him for all of the extra time that he devoted to the practice. What is the impact, if any, on the total amount of "qualified business income" under **Code §199A** for purposes of the 20% deduction?

☞**Sec. 704(b)(2) "Special Allocations" v. Guaranteed Payments to Maximize Sec. 199A Deduction**

Even though a partner's receipt of a "guaranteed payment" for services performed for the entity is closely aligned with that of a "salary" paid to the owner of a closely-held S corporation, Sec. 199A sees it much differently. Even though the wages paid to an owner/employee of an S corporation serve to reduce overall "qualified business income" (QBI), they are available (along with any wages paid to rank-and-file employees) as a support for a potential Sec. 199A deduction. Of course, if a taxpayer's taxable income, before any Sec. 199A deduction, is *below* the applicable "threshold" (i.e.,end of the 24% marginal tax bracket), then the "QBI component" (i.e., 20% x net QBI) is allowed regardless of any "wages" being paid, or UBIA.

In a partnership setting, however, guaranteed payments to partners only serve to *reduce* overall QBI, while providing *no support* for an possible Sec. 199A deduction. As a result, partners should instead look to the use of "special allocations" when seeking to share the profits of the partnership. As long as the special allocation has "substantial economic effect" (as opposed to being done solely for tax purposes), it will be respected if challenged by the IRS.

Example: "Using Special Allocations v. Guaranteed Payments"
John and Dennis have an accounting firm partnership that specializes in tax preparation and consulting. Initially, they agree to a 50/50 split as to all income, deductions and credits resulting from the business. However, when Dennis joined the firm, he insisted on a guaranteed payment of $10,000/month ($120,000/year) and has this put in writing in their partnership agreement. John, on the other hand, being a golf fanatic decides to spend most of Jan. through Mar. in FL seeking to lower his handicap to single digits. This leaves Dennis with the task of getting most of the clients' returns out the door by himself, along with a few staff members. At the end of the year, after paying all of the firm's expenses, a profit of $400,000 is realized, *before* the guaranteed payment to Dennis is factored into the equation.

If the $120,000 guaranteed is deducted on page one of Form 1065, the firm's QBI is *reduced* from $400,000 to $280,000 (which would then be split 50/50 with $140,000 going to each partner as reflected in Box 1 of their respective K-1s). Instead, even if it is done *after* yearend (but by the unextended March 15th due date of the partnership return), Dennis and John can modify their partnership agreement to take into account that Dennis had most of the chargeable hours during the past busy season, thereby justifying a "special allocation" of $120,000 of the firm's $400,000 profit going initially to him. This would result in $360,000 being shown in Box 1 of his K-1, while John would have the remaining $140,000 being reflected in Box 1 of his K-1.

Instead of $280,000 of QBI when $120,000 of the firm's profits are subtracted as a "guaranteed payment" on page one of the Form 1065, "qualified business income" would now remain at $400,000. Furthermore, Dennis would pay self-employment tax on $360,000 (as shown in Box 14 of his K-1) regardless of him receiving this "guaranteed payment" as opposed to a "special allocation" of the same amount. More importantly, this allocation has "substantial economic effect" because it is based on the work effort and resulting profit stemming from the chargeable hours brought in by each partner. **(Code §704(b)(2); Special Allocations**)

Code §754 - Sec. 754 Step-up Election:

☞IRS Provides Procedures for Revoking Sec. 754 Election

The IRS has provided its employees with updated **procedures** to use when determining whether to approve or deny a partnership's request to revoke its **Code §754** election to adjust partnership property basis. Furthermore, this guidance applies to any partnership, whether subject to **TEFRA**, the **BBA**, or separate deficiency proceedings.

Sec. 754 Election: A partnership may elect to adjust the basis of its property after:

1. A distribution of partnership property, or

2. Certain transfers of a partnership interest.

To make the election, a partnership must attach a statement to the partnership's timely-filed return (including extensions) for the tax year in which a distribution or transfer occurs. The statement must include:

1. The name and address of the partnership, and

2. A declaration that the partnership is making a **Code §754 election**.

Once this election is made, it applies to *all* distributions and transfers made during the tax year for which the election is initially filed, and to *all* such transactions in any subsequent tax year unless the election is revoked. This election can only be revoked with permission of the IRS Commissioner. (**IRS.gov/Sec. 754 FAQs**)

Sec. 754 Revocations: A partnership that wants to revoke its **Code §754** election should file its revocation request using **Form 15254, Request for Section 754 Revocation**, no later than 30 days after the close of the partnership's tax year. **Form 15254** must state the reason(s) for requesting a revocation. The regulations provide examples of situations that may warrant the IRS approving a partnership's revocation application. (**Reg §1.754-1(c)**)

These examples include:

1. A change in the nature of the partnership's business;

2. A "substantial increase" in the partnership's assets;

3. A "change in the character" of the partnership's assets; or

4. An "increased frequency" of retirements or shifts of partnership interests.

A revocation application will *not* be approved when the revocation's purpose is primarily to avoid a reduction in the basis of partnership assets upon a transfer or distribution of partnership property.

> **Comment:** Taxpayers used to employ a deliberate "technical termination" (i.e., more than 50% change in particular partner's interest within a 12-month period) to achieve the same result, namely the revocation of a Sec. 754 election previously made. But, with the passage of the **TCJA**, this was no longer possible since "technical terminations" have been eliminated in the tax law. Moreover, as stated above, the IRS will *not* approve such revocations in those situations where it would be most common (i.e., when the revocation's purpose is primarily to avoid a reduction in the basis of partnership assets upon a transfer or distribution of partnership property).

In addition, the IRS has updated procedures for reviewing revocation application requests on **Form 15254**. These procedures cover:

- Processing the **Form 15254**
- Making the determination to approve or reject the revocation request
- Getting managerial approval of the determination
- Sending the recommended determination to Chief Counsel for review
- Obtaining the proper signatures for the determination letter, and
- Document retention procedures. **(Code §754; Sec. 754 Elections)**

☞**IRS Issues Final Regs on Signature Removal for Sec. 754 Election (TD 9963)**

The IRS has issued final rules on how to make a valid election to adjust the basis of partnership property after the partnership makes a property distribution or a partnership interest is transferred. Under **Code §754**, after a partnership makes a distribution of partnership property, or an interest in the partnership is transferred, the partnership may make an election to adjust the basis of the remaining partnership property. Generally, a partnership makes a basis adjustment election in a written statement that's filed with the partnership's return for

the year of the distribution or transfer. Proposed regulations (REG-116256-17) removed the partner signature requirement for a valid election under **Reg. §1.754-1(b)**. These final regulations adopted the October 2017 proposed regulations without change for tax years ending on or after 8/5/2022. **(Code §754; Sec. 754 Election)**

Code §1250 - Depreciation Recapture:

☞**Unrecaptured §1250 Gain Treatment Avoided on Liquidating Distributions Made Out of Real Estate LLCs**
Consider a situation where a member of an LLC holding appreciated real estate decides to sell out their interest to an unrelated third party. To the extent that there is any gain due to straight-line depreciation, this will be considered "unrecaptured Sec. 1250 gain" which is taxed at 25%. And, this gain, along with any other Sec. 1231 gain on the property, would flow from Form 4797 to Schedule D. Basically, the rule is that the normal capital gains treatment accorded by **Code §741** is negated by the "hot asset" rules of **Code §751**. Surprisingly, there is a different answer where this partner or LLC member has their interest terminated by receiving a liquidating distribution from the entity itself. **Reg.§1.1(h)-1(b)**, (which deals with the appropriate tax rates in various situations) indicates that the 25% rate does *not* come into play, as well as the **Code §751** "hot asset" rules *not* being imposed, where the interest is *redeemed* instead of being sold to an outside third party. As a result, the exiting partner receives Sec. 1231 treatment on the *entire* gain, and absent any Sec. 1231 losses for the current year (or prior 5 years that have *not* otherwise been recaptured), this entire gain would flow to Schedule D. **(Code §1(h); Unrecaptured Sec. 1250 Gain)**

> **Comment:** If the real estate market was depressed in some areas of the country, it might not be unusual to see LLC members wanting to perhaps cash out of their ownership interests. By having the entity refinance their real estate holdings and redeem this member's interest, they will be able to exit with capital gains treatment (vs. certain 25% unrecaptured Sec. 1250 gain). Of course, the remaining members of the LLC would then be stuck with this exiting member's share of 25% gain when they sold their respective interests (or, just had the entity sell the property with the proceeds being passed out on the dissolution of the entity).

Code §6103 - Return Disclosure:

☞**Partners Entitled to Receive Partnership Administrative File Records**
The IRS's **Privacy, Governmental Liaison and Disclosure** division issued guidance that says that partner(s) (or, a partnership representative) are entitled to request and receive administrative file record(s) containing partnership returns and return information. This memo also states that **Code §6103(e)(10)** (i.e., limitation on certain disclosures to persons having a material interest) does *not* apply to such a request.

Background - Return Disclosure: The Code provides that, in the case of a partnership return, the return of a partnership must, upon written request, be open to inspection by, or disclosure to, *any* person who was a member of such partnership during *any* part of the period covered by the return. (**Code §6103(e)(1)(C)**) But the disclosure of partnership returns is also limited by the provisions of **Code §6103(e)(10)** which provides that, in the case of an inspection or disclosure under **Code §6103(e)** (i.e., relating to the return of a partnership, S corporation, trust, or an estate), the information inspected or disclosed may *not* include any supporting schedule, attachment, or list which includes the taxpayer identity information of a person other than the entity making the return or the person conducting the inspection or to whom the disclosure is made.

Disclosures of returns and return information subject to **Code §6103(e)** (i.e., disclosure to persons having a "material interest") can also be made under the **Freedom of Information Act (FOIA)**, as well as pursuant to **Reg. §301.9000-1** through **Reg. §301.9000-7** (i.e., "other disclosure methods").

An "IRS administrative file" is a return and/or other documents such as work papers, schedules, audit reports, etc., that are related to a taxpayer's account regardless of whether the documents are physically with the return or maintained separately by IRS. (**IRM 3.5.61.1.8(1)**)

Background - Partnership Audits: The **Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)** created procedures which require that an examination of any partnership items be handled in one partnership-level proceeding and *not* at the partner level. This "TEFRA process" generally applies to tax years *prior* to 2018. TEFRA also created the Tax Matters Partner (TMP) who is the primary contact during a TEFRA examination.

Sec. 1101 of the **Bipartisan Budget Act of 2015 (BBA)** repealed the TEFRA partnership procedures. BBA is generally effective for tax years *after* December 31, 2017. After that date, partnerships are required to designate a "partnership representative." The partnership representative has the sole authority to act on behalf of the partnership. The partnership representative does *not* have to be a partner. Nevertheless, their actions will serve to bind the partnership and all partners of such partnership in dealings with the IRS.

IRS Guidance Regarding Disclosure Rules: This IRS memo notes that **Code §6103(e)(10)** applies to a request made for a partnership return. But it does *not* apply to a request made (i.e., by any partner or partnership representative) under the other disclosure methods discussed above (such as a FOIA request) for access to IRS administrative file record(s), pertaining to a partnership. As a result, partner(s) or a partnership representative are entitled to request and receive administrative file record(s) containing partnership returns and return information. **Code §6103(e)(10)** does *not* apply to these requests. **(Code §6103; Return Disclosure)**

Code §6501 - Limitations on Assessment and Collection:

☞**Individuals' SOL Extension Also Extended Assessment Date for Their Partnership Income (*Inman Partners*, TC Memo 2018-114 (7/23/2018))**

The Tax Court confirmed that, where several individuals who were partners in a partnership each agreed to extend the statute of limitations (SOL) on assessment for any income tax on any return made by or for them "for the period ended Dec. 31, 2000," the extension also applied to partnership items from the partnership whose tax year ended Dec. 19, 2000. **(Code §6501; Statute of Limitations)**

Code §6698 - Failure to File Partnership Return:

☞**Partnerships Must Still File Returns Despite Limited Exemption from Failure-to-File Penalty (CCA 201733013)**

Normally, partnerships that fail to timely file a partnership return are subject to a failure-to-file penalty under **Code §6698** unless "reasonable cause" is shown. **Rev. Proc. 84-35** provides a limited exception to this rule for domestic partnerships with 10 or fewer individual partners if all partners report their proportionate shares of income and deductions on timely-filed returns. In this recent Chief Counsel Advice, the IRS concluded that **Rev. Proc. 84-35** does *not* provide an automatic exemption to partnerships from the actual requirement of filing Form 1065. The justification is that the IRS does *not* know how many partners are in the partnership or whether all of the partners timely filed their income tax returns unless and until the partnership (or, one of its partners) is selected for audit. **(Code §6698; Failure-to-File Penalty)**

C CORPORATIONS:

Code §61 - Gross Income:

☞**Yet Another Case Where Advances from Family Business Were Additional Compensation and Not Loans (*Caiping Zang and Tao Liu*, TC Memo 2017-55 (4/3/2017))**

The Tax Court has upheld the IRS's determination that these married taxpayers had unreported income for three years, including wages, rental income, gambling income, along with significant advances from a company of which they were sole officers and which was controlled by the husband's father. The Court rejected their claim that the advances were loans, finding that there were no indications at the time the funds were advanced that "the parties intended to create a bona fide debtor-lender relationship."

As demonstrated in numerous cases to-date on this issue, in determining whether a bona fide loan exists between a company and its owner, the Tax Court considers:

1. The ability of the borrower to repay;
2. The existence or nonexistence of a debt instrument;
3. Security, interest, a fixed repayment debt, and a repayment schedule;
4. How the parties' records and conduct reflect the transaction;
5. Whether the borrower has actually made repayments;
6. Whether the lender had demanded repayment;
7. The likelihood that the loans were disguised compensation for services; and
8. The testimony of the purported borrower and lender.

> **Comment:** Look to the Tax Court's decision in ***Kaider*, TC Memo 2011-174 (7/20/2011)** which also provides an excellent overview and discussion of these factors. **(Code §61; Company Loans)**

Code §331 - Accumulated Earnings Tax:

☞**Is Accumulated Earnings Tax Penalty Making a Comeback?**

Recently, there has been some concern as to whether the low corporate tax rate is triggering more accumulated-earnings-tax audits? Apparently, that might indeed be the case as we are currently seeing an increase in such audits. The **TCJA** lowered the C corporation tax rate to a flat 21%. And, arguably, this low rate, when compared with the 37% top individual marginal rate, makes C corp status beneficial, especially for those companies that retain earnings rather than pay dividends to their owners.

The accumulated earnings tax penalty rate is 20% (i.e., the highest rate on dividends) of earnings accumulated in excess of the *larger* of $250,000 or accumulations needed for "reasonable business needs" (RBNs), such as growth of the firm, debt retirement, shoring up the firm's pension plan or covering the loss of a principal customer. The minimum accumulation allowed for service corporations is $150,000. Firms with excess accumulated earnings and a history of *not* paying dividends, or paying small dividends, could face increased IRS audit exposure.

Clients should be advised to document the business purpose (i.e., RBNs) for accumulating earnings by including a description of the plans and decision-making processes in the corporate minutes and budget forecasting documents, to the extent that significant funds are set aside for such purposes. **(Code §531; AET Penalty)**

Code §1202 - Qualified Small Business Stock Exclusion:

☞**Qualified Small Business Stock Rules Can Convert Startup Profits into 100% Tax-Free Gains**

Venture capitalists and private equity groups are starting to take a closer look structuring startups so as to qualify under the "qualified small business stock" (QSBS) provisions of **Code §1202**. And, if they can meet these requirements, the benefits of doing so are fairly clear. This often-overlooked Code provision can convert some or

all of the profit on a successful investment in a startup into tax-free gain.

Comment: The biggest problem with this QSB tax break is that it only covers C corporations. Yet arguably, over 90% of all business returns are filed as passthrough entities. Furthermore, even if a C corporation is involved, numerous types of businesses conducted by C corporations are excluded from the definition of a "qualified small business" and there are a number of other prerequisites that have to be satisfied.

Comment: This is an extremely complex area for which the IRS has failed to issue much in the way of guidance (i.e., regulations, rulings, etc.). What we have at this point is just a few rulings dealing with the health care industry, and one on an Air BnB-type website that was found to be in a "disqualified" brokerage business. And, the Tax Court has only dealt with one case thus far on **Code §1202**. Nevertheless, tax practitioners need to be aware of the basics in this area and what steps they can take to ensure that their clients might eventually qualify for this extraordinarily tax break. And, when it comes time to consider going public and selling some or all of a founder's stock, it would be wise to obtain a "substantial authority" letter from a law firm that specializes in this gain exclusion.

Background: *Noncorporate* taxpayers may exclude from gross income 100% of any gain realized on the sale or exchange of QSBS held for *more than five years* if the QSBS is acquired *after* Sept. 27, 2010 and *before* Jan. 1, 2012. This deadline was later eliminated and the 100% exclusion is what the current law provides.

The exclusion was 75% of gain realized on the sale or exchange of QSBS acquired *after* Feb. 17, 2009 and *before* Sept. 28, 2010, and 50% of gain realized on the sale or exchange of QSBS acquired *either* before Feb. 18, 2009, or after Dec. 31, 2011. But, there is a a cumulative and annual dollar limitation on how much gain may be excluded. (**Code §1202(a)(4), Code §1202(b)(1), Code §1202(b)(2)**) Previously, there was an AMT preference for a portion of gain from the sale or exchange of QSBS that was excluded from gross income for regular tax purposes under **Code §1202**. But that AMT provision no longer applies to QSBS. (**Code §1202(a)(4)(C)**)

A noncorporate taxpayer's net capital gain that is "adjusted net capital gain" is taxed at a maximum rate of 15%. And, if the adjusted net capital gain would otherwise be taxed at a rate below 22% (i.e., either 10% or 12%), it is taxed at a *zero* percent rate. (**Code §1(h)(1)(B), Code §1(h)(1)(C)**) Net capital gain attributable to "section 1202 gain" (i.e., that portion of the QSBS gain that is *not* excluded) is taxed at a maximum rate of 28%. (**Code §1(h)(1)(E), Code §1(h)(4)**) "Section 1202 gain" is the excess of: (1) the gain that would be excluded from gross income on the sale of certain QSBS under **Code §1202**, if the percentage limitations of **Code §1202(a)** did *not* apply, over (2) the gain actually excluded under **Code §1202**. (**Code §1(h)(7)**)

Qualifying as QSBS: Stock qualifies as QSBS only if it meets *all* of the following tests (**Code §1202(c), Code §1202(d)**):

(1) It must be stock in a C corporation (i.e., *not* S corp stock) originally issued after Aug. 10, '93.

Comment: As mentioned above, this might be the biggest hurdle for our clients who are almost exclusively S corps or LLCs taxed as partnerships. And, simply revoking the S election, while waiting out the 5-year holding period, would *not* suffice since (as mentioned below), as of the date the stock was issued, the corporation was a domestic C corporation (let alone, a QSB).

(2) As of the date the stock was issued, the corporation was a domestic C corporation with total gross assets of $50 million or less: (a) at all times after Aug. 9, '93, and before the stock was issued, and (b) immediately after the stock was issued. For this purpose, "gross assets" include those of any predecessor of the corporation, and all corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.

Comment: Even though the company must be relatively small when it starts out, if all the aforementioned conditions are met, the **Code §1202** exclusion is available no matter how large it might eventually grow (e.g., PayPal whose stock was purchased and issued to the individual's Roth IRA and which was worth millions when the company went public).

(3) In general, the taxpayer must have acquired the stock at its original issue (either directly or through an underwriter), either in exchange for money or other property or as pay for services (other than as an underwriter) to the corporation.

(4) During substantially all the time the taxpayer held the stock:

- The company was a C corporation;

Comment: Normally, it is not unusual for startup businesses to initially elect to be S corporations so that they can pass through to their shareholders losses that they anticipate incurring in their early years of operation. Nevertheless, the decision to make an S election should be reexamined if the shareholders anticipate taking advantage of the QSBS gain exclusion, if the S election results in the corporation *not* being a C corporation during "substantially all" of a given shareholder's holding period for the stock. Unfortunately, neither Congress nor the IRS has clarified what will be considered "substantially all" of a shareholder's holding period for this purpose.

- At least 80% of the value of the corporation's assets were used in the active conduct of one or more qualified businesses; and

- The corporation was *not* a foreign corporation, domestic international sales corporation (DISC), former DISC, regulated investment company (RIC), real estate investment trust (REIT), real estate mortgage investment conduit (REMIC), financial asset securitization investment trust (FASIT), cooperative, or a corporation that has made (or that has a subsidiary that has made) a **Code §936** election.

Active Conduct of a Qualified Business: For purposes of the rule requiring 80% of the value of assets to be used in the conduct of a "qualified business," all of the following are treated as used in the active conduct of a qualified business:

(1) Assets used in certain activities with respect to future "qualified businesses," without regard to whether the corporation has any gross income from these activities at the time this rule is applied. Those activities are: (a) **Code §195(c)(1)(A)** start-up activities; (b) activities that result in the payment or incurrence of qualifying research and experimental expenditures under **Code §174**; and (c) activities with respect to in-house research expenses. (**Code §1202(e)(2)**)

(2) Assets held to meet the reasonably required working capital needs of a qualifying business, and assets held for investment that are reasonably expected to be used *within two years* to finance research and experimentation in a qualified business or to finance increases in working capital needs of such a business. (**Code §1202(e)(6)**) But, after the corporation has been in existence for at least two years, *no more than 50%* of its assets may qualify as being used in the active conduct of a qualified business by reason of these rules. (**Code §1202(e)(6)**)

(3) The rights to computer software which produces active business computer software royalties as defined in **Code §543(d)(1)**. (**Code §1202(e)(8)**)

A corporation will be treated as failing to meet the active business requirement for any period during which: (1) more than 10% of the value of its assets in excess of its liabilities consists of stock or securities in other corporations which are *not* subsidiaries of the corporation, other than working capital assets; or (2) more than 10% of the total value of its assets consists of real property which is *not* used in the active conduct of a qualified business (for this purpose, owning, dealing in, or renting real property is *not* considered to be the active conduct of a qualified business). (**Code §1202(e)(5)(B), Code §1202(e)(7)**) On the other hand, a corporation will be treated as meeting the active business requirement for any period during which it is a "specialized small business investment company" (SSBIC). (**Code §1202(c)(2)(B)(I)**)

Qualified Business: For QSBS purposes, a "qualified business" (even if it is a C corporation and it otherwise meets the above-mentioned conditions) is one that is *not*:

- A business involving services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services. This would include those businesses "where the skill or reputation of its owners or employees is considered to be its principal asset."

Comment: Note that this first rule is limited to service-type businesses, while the second rule, below, is *not* so limited. But, this definition of "service businesses" does extend beyond the normal definition of a PSC (i.e., as defined under **Code §444**)

- A business whose principal asset is the reputation or skill of one or more employees.

Comment: There is no other instance in which either the Code or the regs use the term "principal asset" in the context of an intangible human quality like "reputation" or "skill." And, the relevant Congressional Committee reports do *not* add any insight as to Congress' intent with respect to this language. As a result, it is quite unclear which trades or businesses will fail the "qualified business" test due to this language.

Comment: The IRS has stated that one may *not* look to the legislative regs issued for **Code §199A** in making this determination regarding "skill or reputation."

- A banking, insurance, financing, leasing, investing, or similar business.

- A farming business (including the raising or harvesting of trees).

- A business involving the production of products for which percentage depletion can be claimed.

- A business of operating a hotel, motel, restaurant, or similar business.

Comment: Given these exclusions above, it is going to be fairly difficult to qualify many of our clients' businesses for this special tax break. And, this is after the fact that the company has to be a regular C corporation to begin with.

Dollar Limit on Eligible Gain: For each tax year, for each corporation in which the taxpayer sells or exchanges QSBS, the amount of gain eligible for the exclusion is *not* permitted to exceed the *greater* of:

(1) $10 million ($5 million for married persons filing separately), less the total amount of eligible gain (i.e., gain on the sale or exchange of QSBS held for more than five years) taken into account under the **Code §1202(a)** rules by the taxpayer with respect to dispositions of stock issued by the corporation in all earlier tax years, or

(2) ten times the taxpayer's total adjusted basis in QSBS of the corporation disposed of by the taxpayer in the tax year. (**Code §1202(b)(1)**)

Other Rules: These complex QSBS requirements also include anti-abuse provisions (**Code §1202(c)(3)**), special rules for taxpayers or related parties that take certain short positions in the stock (**Code §1202(j)**), stock held by passthroughs (**Code §1202(g)**), and gifts and bequests (**Code §1202(h)**). **(Code §1202; QSB Stock)**

Comment: Surprisingly, though, original holders of QSB stock can take advantage of "**stacking and packing**" with family members and other related parties to obtain multiples of this "$10 million cap per shareholder."

Notes:

S CORPORATIONS:

Miscellaneous:

☞**Letter Rulings Not Needed for Some Defective S Corp Election Requests (Rev. Proc. 2022-19)**
The IRS has issued guidance providing "taxpayer assistance procedures" which will allow S corporations and their shareholders to resolve "frequently encountered issues with certainty and without requesting a private letter ruling."

The IRS has identified issues that will *not* be treated as affecting the validity (or, continuation) of a corporation's election under **Code §1362(a)**, or to be treated as an S corporation under **Code §1361(b)(3)(B)(ii)** including its corporate subsidiary as a qualified subchapter S subsidiary (QSUB). The revenue procedure also provides "retroactive corrective relief procedures" under **Code §1362(f)** to allow taxpayers to preserve S elections that "are invalid or terminated solely as the result of one or more nonidentical governing provisions." The guidance further provides the specific areas in which the IRS will *not* rule (or, will *not* ordinarily rule), regarding the validity (or, continuation) of an S election or a QSub election.

> **Comment:** According to the IRS, this guidance is intended "to reduce burdens, facilitate increased compliance with S election and QSUB election rules, and reduce costs and delays for completing transactions involving S corporations and QSUBs."

The six areas for which issues "are resolvable without a letter ruling" are:

- The "one-class-of-stock requirement" and governing provisions, including "principal purpose" conditions; disproportionate distributions; some inadvertent errors or omissions on **Form 2553** or **Form 8869**

> **Comment:** An "inadvertent error" would include where a shareholder failed to sign the **Form 2553** S corp election.

> **Comment:** Even though a "disproportion distribution" pattern would *not* cause the revocation of the S corp election, if this was discovered for instance with a new client, they should be told to "cease and desist" paying out such amounts to only certain shareholders.

- Missing administrative acceptance letters for an S election or QSUB election

- Federal income tax return filings inconsistent with an S election or a QSub election

- Potential retroactive corrections of "nonidentical governing provisions"

> **Comment:** The revenue procedure has complete details regarding the areas in which a letter ruling will *not* ordinarily be issued. As a result, it serves to amplify and modify **Rev. Proc. 2022-3**. Appendices to the revenue procedure also include a sample "corporate governing provision statement" and a sample "shareholder statement."

> **Comment:** The revenue procedure, which includes a transition rule for pending letter ruling requests, is generally effective October 11, 2022. Also, **Rev. Proc. 2013-30** and portions of **Rev. Proc. 2022-1** are *amplified*. **(Misc.; S Corporations)**

☞**S Corporations Required to List Shareholder Loans on K-1**
The IRS will now be provided information on shareholder loans made to their S corporations. It has revised the **2020 Schedule K-1, Part II, Box H** that is issued to each S firm shareholder which will report of the amount of any debt owed by the firm to that shareholder (i.e., "direct shareholder loans") at *both* the beginning and end of the year. Corporate debt owed to third parties for which the shareholder is a co-borrower or guarantor is *not* to be included. **(Code §1367; Shareholder Loans)**

Comment: And, on **Schedule E, page 2**, you will continue to provide an information regarding the repayments made on "direct shareholder loans" to that particular shareholder.

Code §162 - Self-Employed Health Insurance Deduction:

☞**Shareholder's Payment of S Corp Bills Treated as Capital Contributions (*Vorreyer*, TC Memo. 2022-97 (9-21-2022))**

S corp shareholders were *not* permitted to deduct a payment that they made on behalf of an S corporation. The two taxpayers in question owned all the stock in an S corporation and decided to pay the company's utility bill and property taxes while seeking to deduct the amounts on their personal tax returns. The Tax Court agreed with the IRS that the payments should have instead been treated as capital contributions from the owners to the firm and deducted by the company. **(Code §162; Capital Contributions)**

Comment: The corporation never did, in fact, claim these deductions which would have reduced the K-1 amount otherwise reported on page two of the shareholders' Schedule Es. This same result would also hold true if a partner chose to personally pay the otherwise deductible expenses of the partnership on their Form 1040.

☞**"Self-Employed" Health Insurance Deduction for Employee Family Members of > 2% Shareholders (CCA 201912001)**

The IRS has clarified that an individual who is a 2% shareholder of an S corporation as a result of the "attribution rules" under **Code §318** is entitled to the deduction under **Code §162(l)** (i.e., "self-employed health insurance deduction") for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of **Code §162(l)**.

Comment: Was this clarification actually needed? Typically (i.e., based on **Rev. Rul. 91-26**), the shareholder/employee of an S corporation has "family coverage" whereby the *entire* premium for the family unit is included in their W-2 wages (but, *not* subject to any employment taxes). Then, with these wages included on the owner's **Form 1040**, a corresponding "self-employed health insurance deduction" is subtracted. Where this guidance might apply is where an adult family member of the S corporation is treated as a "2% shareholder" due to the attribution rules and otherwise has their health insurance paid for (or, premium costs reimbursed) by the S corporation (and, is *not* covered by any "subsidized health plan" (e.g., cafeteria plan or HRA).

Background: **Code §1372(a)** provides that, for purposes of applying the provisions of the Code relating to employee fringe benefits, an S corporation is treated as a partnership, and any 2% shareholder of the S corporation is treated as a partner of such partnership. For purposes of **Code §1372**, the term "2% shareholder" is *any* person who owns (or, is considered as owning within the meaning of **Code §318**) on *any* day during the tax year of the S corporation > 2% of the outstanding stock of such corporation or stock possessing > 2% of the total combined voting power of all stock of such corporation. (**Code §1372(b)**) **Code §318(a)(1)** provides that an individual is considered as owning the stock owned, directly or indirectly, by or for his spouse, children, grandchildren, and parents.

An S corporation is entitled to deduct the cost of accident and health insurance premiums paid or furnished by an S corporation on behalf of its 2% shareholders under **Code §162(a)** if the requirements of that section are satisfied. The 2% shareholder is required to include the amount of the accident and health insurance premiums in gross income under **Code §61(a)**. (**Notice 2008-1**)

Code §106 provides an exclusion from the gross income of an employee for employer-provided coverage under an accident and health plan. However, a 2% shareholder of an S corporation is *not* an employee for purposes of **Code §106**. (**Reg. §1.106-1; Code §1372(a)**)

Code §162(l)(1)(A) allows an individual who is an employee within the meaning of **Code §401(c)(1)** (i.e., a self-employed individual) to take a deduction in computing adjusted gross income for amounts paid during the tax

year for insurance that constitutes medical care (i.e., under Code §213) for the taxpayer, his or her spouse, and dependents. However, the deduction is *not* allowed to the extent that the amount of the deduction exceeds the earned income derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established. (**Code §162(l)(2)(A)**) Also, the deduction is *not* allowed for amounts during a month in which the taxpayer is eligible to participate in any "subsidized health plan" maintained by an employer of the taxpayer or of the spouse of the taxpayer. (**Code §162(l)(2)(B)**)

A 2% shareholder-employee in an S corporation, who otherwise meets the requirements of **Code §162(l)**, is eligible for the deduction under **Code §162(l)** if the plan providing medical care coverage for the 2% shareholder-employee is established by the S corporation. (**Rev. Rul. 91-26**) A plan providing medical care coverage for the 2% shareholder-employee in an S corporation is treated as being "established" by the S corporation if:

1. The S corporation makes the premium payments for the accident and health insurance policy covering the 2% shareholder-employee (and, his or her spouse or dependents, if applicable) in the current tax year; or

2. The 2% shareholder makes the premium payments and furnishes proof of premium payment to the S corporation and then the S corporation reimburses the 2% shareholder-employee for the premium payments in the current tax year.

In order for the 2% shareholder-employee to deduct the amount of the accident and health insurance premiums, the S corporation must report the accident and health insurance premiums paid or reimbursed as wages on the 2% shareholder-employee's **Form W-2** in that *same* year. In addition, the shareholder must report the premium payments or reimbursements from the S corporation as gross income on his individual tax return.

Facts: An individual owns 100% of an S corporation, which also employs the individual's family member. The family member is considered to be a 2% shareholder pursuant to the attribution of ownership rules under **Code §318**. The S corporation provides a group health plan for all employees, and the amounts paid by the S corporation under such group health plan are included in the family member's gross income.

IRS Ruling: Pursuant to the rules described above, an individual who is a 2% shareholder of an S corporation pursuant to the attribution of ownership rules under **Code §318** is entitled to the deduction under **Code §162(l)** for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income, if the individual otherwise meets the requirements of **Code §162(l)**. **(Code §162; S/E Health Insurance Deduction)**

> **Comment:** Taxpayers who qualify under **Code §162(l)** can convert what might otherwise be a nondeductible expense (i.e., due to either the 7.5 % (or,10%) AGI floor for medical expenses in Code §213(a) or the fact that the taxpayer takes the standard deduction) into an "above the line" deductible item.

Code §1361 - S Corporation Defined:

☞**Careful Planning Needed for LLCs Elect S Corp Status**

Although the self-employment tax savings can be powerful tax incentive when considering the conversion of an LLC taxed as a partnership to an S corporation, careful consideration should be given to those situations where guaranteed debt has been used as additional at-risk basis for taking partnership K-1 losses. The key factor is that this additional basis will immediately be lost since, under the S corporation basis rules, guaranteed debt is *not* counted (at least not until actual payments have to be made by the guarantor). Instead, only "direct shareholder loans" can be used to create additional basis beyond any stock basis (which is derived from original, as well as additional, capital contributions, along with net income to-date).

> **Comment:** Other reasons for an LLC to make an S election might be to avoid the imposition of either the .9% or the 3.8% Medicare surtaxes (i.e., by instead making distributions of S corp profits), or simply

because these partners would rather be able to take W-2 payroll v. having to receive guaranteed payments (i.e., and thus avoid, perhaps, having to make estimated tax payments throughout the year while also only having to pay the *employee's* share of payroll taxes instead of self-employment tax).

Comment: A critical planning step where guaranteed debt has been used as additional at-risk basis is to do a "novation" whereby the guarantor becomes the *primary* obligor instead of merely remaining a *secondary* obligor (who the lender looks to only when the entity has failed to make sufficient payments on the outstanding principal balance). However, many lenders do not understand this concept of "novation" even though it leaves them in the *same* position of security with regard to the debt (i.e., they have *both* the entity as well as the owners to go after for full repayment of the debt).

Another possible tax trap can be the used of "qualified nonrecourse real property indebtedness" as additional basis in those instances where the LLC holds real estate which is subject to a mortgage. Once again, the tax law contains a loophole (which was negotiated many years ago by the real estate tax shelter lobbyists) that despite no one being personally liable for the repayment of the mortgage, it is nevertheless counted as additional "at-risk basis" (as shown on **Form 6198**) for taking K-1 losses.

The bottom line is that if either if these exceptions have been used to create additional at-risk basis for taking losses, **Code §465(e)** will apply and result in"at-risk recapture." This, in turn, means that these new S corp shareholders will have immediate income recognition to the extent that they no longer have this basis for taking the earlier partnership losses that had previously flowed through to them on their respective K-1s.

Comment: The character of the income needing to be picked up in the owner's income is dependent upon the character of the loss that had previously been taken.

On a separate note, another key consideration on making the switch from LLC partnership status to that of an S corporation is "negative capital accounts." For instance, a partner who has guaranteed a debt can use this additional "soft basis" for taking a distribution that is in excess of the "hard basis" (i.e., that basis derived from capital contributions along with their share of any K-1 net income to-date) that they otherwise have in their partnership interest. In fact, *all* liabilities, even if they are *not* "at-risk" (e.g., nonrecourse debt) count for basis when determining whether a partner has sufficient basis with regard to the possible taxation of a distribution. In other words, there is no need to fill out **Form 6198** in order to determine "at-risk basis" when a distribution is made and whether or not it is taxable to the partner receiving it.

Again, when the S election becomes effective for a former LLC taxed as a partnership, the rules for capital accounts do *not* permit an S corp shareholder to have a "negative" balance. As a result, any shareholder who as a former partner had a deficit in their capital account would now have to pick up that excess as income in the first year of the S corporation's existence.

One final note concerns LLCs where there is plenty of income to cover distributions but with only some partners taking distributions while other partners do not. For instance, consider a profitable accounting firm equally owned by two partners, Steve and John. Over the course of several years, Steve has drained his share of the firm's profits to the extent of his share of K-1 income. Meanwhile, John has only extracted his share of the firm's profits to the extent needed to cover his estimated income tax liability. If this situation is *not* rectified by the time that the S election takes effect (i.e., by John taking a corresponding amount of distributions out of the LLC to even out the situation with his partner Steve), then the general rule that all S corp distributions be pro rata will come into play.

Comment: It is one thing to allow a disproportionate distribution to "make up" for prior mistakes in this area (or, where state or local income taxes have to be deposited on behalf of nonresident shareholders), but to cause an S corp to make significantly larger disproportionate distribution so as to make up for sizable unequal distributions from prior years as a partnership would be very hard to defend.

Comment: Another completely separate issue should also be considered when choosing to convert an LLC taxed as a partnership to an S corporation. Namely, the various types of ownership units a partnership entity might have outstanding. Differences in voting rights are permitted should a switch be made to S corp

status. But, any other distinctions among the partners' respective interests would have to be resolved before the effective date of the S election since only one class of common stock is permitted. And, as far as what would be the initial basis of their S corp stock for tax purposes, it would most likely be whatever the final basis in their partnership interest had been, adjusted for the possible scenarios mentioned above. **(Misc.; Capital Accounts)**

Code §1367 - S Corporation Stock Basis:

☞Revised Form 7203 S Corp Basis for 2022 Returns

Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations (Rev. Dec. 2022), replaces a three-part worksheet for figuring a shareholder's stock and debt basis that used to be found in the **Shareholder's Instructions for Schedule K-1 (Form 1120-S)**. The IRS first introduced **Form 7203** in 2021 and appears to be changing it only slightly for 2022 tax year filing purposes.

Comment: Part II on **Page 2, Form 1040, Schedule E** continues to require the filing of **Form 7203** "If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation." If that is the case, then "you must check the box in **column (e)** on **line 28** and attach the required basis computation" (i.e., on **Form 7203**).

Comment: For tax years *before* 2021, the instructions for **Schedule K-1 (Form 1120-S)** contained a three-part worksheet that shareholders could use to track their stock bases year by year. As a worksheet in the instructions, however, it was *not* something that shareholders needed to file with their personal tax returns.

Comment: The IRS recommends that shareholders complete (and hold onto) **Form 7203** even in years in which they are *not* required to file it, simply to keep track of both their stock and debt bases.

Changes to Revised Form 7203: The draft **Form 7203** for tax year 2022 makes only two changes to the 2021 form as follows:

- **New Item D:** Shareholders will need to check a box (or, boxes) to show how they acquired the stock in the S corporation. The draft instructions say that the shareholder should check "Other" if they acquired the stock in some other way other than by purchasing it, inheriting it, receiving it as a gift, or obtaining it as an original shareholder.

- **New Item E:** This new item asks shareholders whether they have an election in effect for the tax year to reduce the shareholder's basis for the share of S corporation losses and deductions *before* reducing basis for *nondeductible* items (e.g., 50% of meals and 100% of entertainment expenses). In other words, the election *reverses* steps (3) and (4) in the process of reducing basis on the **Form 7203**.

Comment: The shareholder may want to consider making the election to avoid deferring their deduction for losses if they do *not* have sufficient basis remaining *after* reducing it for *nondeductible* expenses. This is because if this election is made, any *nondeductible* expenses would then have to be carried over to the subsequent tax year.

Comment: Remember that this election is solely for S corp shareholders and is *not* available for partners or LLC members (i.e., who are always required to reduce basis in their partnership interest by *nondeductible* items first). **(Code §1367; Form 7203)**

☞Form 7203 - Stock Basis Calculation for S Corp Shareholders

Comment: S corp shareholders are required to include basis information with their personal tax returns. This requirement applies to shareholders who report a loss, dispose of their stock, or receive a distribution or loan repayment from the company. Shareholders must check a box on **Line 28** of **Schedule E** and

attach this new **Form 7203** basis computation.

Comment: Shareholder basis in S corporations has become a big IRS enforcement priority since owners are permitted to deduct losses only up to their stock basis and direct personal loans that they made to the company. The Service "knows that compliance in this area is deficient" and is conducting audits which will be at the shareholder level. Agents are checking to see whether shareholders are properly tracking their basis.

A. Introduction

1. According to the IRS, S corporation shareholders use **Form 7203** "to figure the potential limitations of their share of the S corporation's losses, deductions, credits, and other items that can be deducted on their individual returns."

2. **Form 7203** and its separate instructions were developed to replace the "3-part Worksheet for Figuring a Shareholder's Stock and Debt Basis" and its related instructions formerly found in the Shareholder's Instructions for Schedule K-1 (Form 1120-S) (i.e., for pre-2021 tax years).

B. Who Must File Form 7203

1. Form 7203 is filed by S corporation shareholders who:

a. Are claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations);

b. Received a non-dividend distribution from an S corporation;

c. Disposed of stock in an S corporation (whether or not gain is recognized); or

d. Received a loan repayment from an S corporation.

Comment: So, **Form 7203** is *not* just for stock basis, but also to be used to determine possible gain recognition where the S corporation makes a repayment on DSLs ("direct shareholder loans") that might have a "reduced basis."

Example: "Repayment of Reduced Basis Shareholder Loan"

An S corp shareholder makes a $100,000 loan to the company which has a current year loss allocable to this owner equal to $150,000. The shareholder's stock basis is $100,000 as well. As a result, all of their stock basis would be absorbed by this K-1 loss, while $50,000 (of the overall DSL basis of $100,000) would be used to claim the remainder of this $150,000 loss.

The following year the S corporation breaks even and there are no other increases (e.g., capital contributions) to the zero basis that the shareholder continues to have in their stock. Nevertheless, without obtaining any tax advice, the S corporation decides to repay the $100,000 balance outstanding on the DSL out of some working capital reserves.

Since it has a "reduced basis" of just $50,000, 50% of this $100,000 repayment would be taxable (as ordinary income whereas an excess distribution on stock would be LTCG).

Comment: If this S corp shareholder was that desperate in their need for funds, arguably, the S corp should have made a "loan" of this $100,000 (preferably, evidenced by a written document with a stated interest rate) to the shareholder (thus, avoiding the gain due to the repayment stated above). Then, when basis had been completely restored to this DSL, repayment could have occurred without any tax consequences.

Comment: Keep in mind, that basis restoration (e.g., allocable K-1 profit is passed out to an S corp shareholder) serves to restore "debt basis" first, before going to any "stock basis."

C. Limitations on Losses, Deductions, and Credits

1. The potential limitations and the order in which you must apply them for claiming a K-1 loss on Page 2 of Schedule E are as follows:

a. The basis limitations under **Code §1367**;

b. The at-risk limitations under **Code §465** (i.e., as shown on **Form 6198**);

c. The passive activity loss limitations under **Code §469** (i.e., as shown on **Form 8582**); and

d. The "excess business loss limitations" under **Code §461(l)** (i.e., as shown on **Form 461**).

D. Basis Calculation Under Code Sec. 1367

1. Basis is *increased* by (a) all income (including tax-exempt income such as forgiven PPP loan amounts) reported on **Schedule K-1 (Form 1120-S)**, and (b) the excess of the deduction for depletion (other than oil and gas depletion) over the basis of the property subject to depletion.

2. Basis is *decreased* (but not below zero) by (a) the FMV of any property distributions (including cash) made by the corporation reported on **Schedule K-1 (Form 1120-S)**, box 16, code D, minus (b) the amount of such distributions in excess of the current basis in the distributee's stock.

3. Basis is *decreased* (but not below zero) by (a) nondeductible expenses (e.g., 100% of any "entertainment expenses"), and (b) the depletion deduction for any oil and gas property held by the corporation, but only to the extent your share of the property's adjusted basis exceeds that deduction.

4. Basis is *decreased* (but not below zero) by all other losses and deductions (i.e., separately stated and non-separately stated) reported on **Schedule K-1 (Form 1120-S)**.

E. Election to Switch Ordering Rules for Reducing Stock Basis

1. S corp shareholders may elect to switch the "ordering rules" stated above so as to decrease their basis under (4) *prior to* decreasing your basis under (3). But, if this election is made, any amount described under (3) that exceeds the basis of your stock and debt owed to you by the corporation is treated as an amount described under (3) for the *following* tax year. By way of comparison, there is no such election available for partners.

2. To make the election, a statement must be attached to the shareholder's timely-filed original or amended return that states that they agree to the "carryover rule" of **Reg. §1.1367-1(g)** and the name of the S corporation to which the rule applies. Once made, the election applies to the year for which it is made and all future tax years for that S corporation, unless the IRS agrees to revoke this election.

F. Pro Rata Application of Various Types of Losses and Deductions on Schedule K-1

1. The basis of each share of stock is increased or decreased (but not below zero) based on its *pro rata share* of the above adjustments. And, if the total decreases in basis attributable to a share exceed that share's basis, the excess reduces (but not below zero) the remaining bases of all other shares of stock "in proportion to the remaining basis of each of those shares."

2. **Example #1: "K-1 with T/B Loss and Capital Loss"**
Assume that a shareholder has $10,000 basis in their S corporation stock (but, no "direct shareholder

loans”). They receive a K-1 with a Box 1 T/B ordinary loss of $10,000 and a Box 8a LTCL of $10,000. These two respective types of losses would be applied against the shareholder’s available stock basis of $10,000 using a pro rata approach. As a result, the $10,000 stock basis would be completely absorbed with $5,000 of each type of loss being carried over to future tax years.

3. **Example #2: “K-1 with T/B Loss and Nondeductible Entertainment Expenses”**
Assume that a shareholder has $10,000 basis in their S corporation stock (but, no “direct shareholder loans”). They receive a K-1 with a Box 1 T/B ordinary loss of $10,000 and a allocable share of the S corporation’s nondeductible entertainment expenses of $10,000. Under the “ordering rules” mentioned above, the nondeductible entertainment expenses would completely absorb the shareholder’s available basis of $10,000, leaving the entire $10,000 T/B loss to be carried over to future tax years.

Comment: The S corp shareholder (but, *not* a partner) could elect to use their $10,000 stock basis to first absorb the T/B loss. But, that would mean that the entire $10,000 of entertainment expenses would have to be carried over. However, this might make sense if their effective marginal tax rate was much higher in the year of the loss v. what they expect to have in future tax years.

G. Basis Increased by Direct Shareholder Loans to S Corporation

1. When guarantees of loans are so common today, it is critical to understand that any S corporation shareholder/guarantors would *not* receive an increase to their basis (i.e., either for taking K-1 losses or deductions, or for offsetting any distributions made during the tax year to them).

Comment: This is a key distinction when compared to partnership tax law. Under **Code §752(a)** a partner’s basis in their partnership interest is increased by their allocable share of partnership debt, including any debt that the partner has guaranteed. So, if a great of borrowing and outside financing is anticipated, for example with a start-up business, it might make sense to consider using a partnership entity v. an S corporation (i.e., where up-front losses just end up being carried over).

H. DSL Basis Absorbed After Any Stock Basis

1. **Example #3: “T/B Loss with S Corp Distributions in Same Tax Year”**

An S corp shareholder has $10,000 basis in their stock, while also have an outstanding “direct shareholder loan” to the company with a basis of $10,000. Assume that the S corporation has a $10,000 T/B loss while also making a $10,000 distribution to this shareholder during the current tax year.

The $10,000 distribution can only go against the shareholder’s stock basis which would bring it down to zero as of the end of the tax year. Meanwhile, the $10,000 T/B loss would have no stock basis to be offset against, but the DSL basis would then be use to allow the claiming of the loss.

Comment: Had this S corp shareholder only had a $10,000 basis in their stock and no outstanding basis in a DSL, then the $10,000 distribution would absorb the stock basis first with the $10,000 T/B loss having to be carried over to future tax years.

Comment: Same facts as above, but the S corp shareholder has zero basis in their stock as of the end of the tax year (e.g., assume that all available basis was absorbed by distributions made during the year). If there was once again a $10,000 T/B loss and $10,000 of nondeductible entertainment expenses, none of the latter expenses would have to be carried over to future tax years. Again, there is no similar rule for partnerships (i.e., both types of losses/deductions would have to be carried over).

I. Restoration of Both Stock Basis and DSL Basis

1. Always remember that neither basis can go below zero, but that “direct shareholder loans” (DSLs) can have a “reduced basis.”

Comment: Since stock basis cannot go below zero (i.e., and, same rule on partner's basis in their interest), that is why cash (or, FMV of property distributions) in excess of current basis has to result in gain recognition so as to maintain the zero basis rule for S corp stock.

2. Again, when distributions are made to an S corp shareholder, that are taken into account first and can only be offset against any *stock* basis (i.e., DSL basis is *not* even considered in determining whether a distribution might be in excess of stock basis and therefore taxable).

3. On the other hand, with a K-1 reports various losses (e.g., T/B or rental) and deductions (e.g., Sec. 179), these items go against stock basis first and then, if available, against any DSL basis.

4. **Example #4: "Restoration of DSL Basis"**

Assume that an S corp shareholder has $10,000 stock basis and a $10,000 DSL basis. The S corp passes out on this shareholder's K-1 their share of a Box 1 T/B loss of $15,000. Given that there were no distributions made to this shareholder during the tax year and no other increases to the stock basis such as a capital contribution made by them to the S corp, $10,000 of the overall $15,000 loss would completely absorb their stock basis of $10,000 first. Then, the remaining $5,000 of the $15,000 T/B loss would serve to reduce the $10,000 DSL basis that they have (i.e., resulting in a "reduced basis DSL" of $5,000).

In the next tax year, the S corporation has a $10,000 T/B profit allocable to this shareholder. Assuming no other increases to this shareholder's stock or debt basis, the first $5,000 of the profit would "restore" the DSL basis to $10,000. The remaining $5,000 of T/B profit would serve to increase the shareholder's stock basis from zero to $5,000.

J. Review of Line Items on Form 2703

1. Looking at the respective line items on **Form 7203** should reinforce that principles covered above.

Comment: With the increased use of both Sec. 179 immediate expensing and 100% bonus depreciation, these write-offs, by themselves, can result in over T/B loss. And, even though this K-1 loss might be suspended due to the lack of basis (or, any of the other "restrictions" mentioned above), the bases of the assets involved still get reduced in full in the meantime.

☞**Basis Wasted from Prior Tax Year Not Available to Take Current K-1 Losses (*Barnes*, 111 AFTR 2d ¶ 2013-611 (CA DC 04/05/2013))**

The Court of Appeals for the District of Columbia, *affirming* the Tax Court's earlier decision, agreed that an S corp's shareholders should *not* be permitted deduct passthrough losses in a situation where they did *not* have sufficient basis in their stock. The key factor in this instance was the taxpayers' failure to take into account suspended losses from previous tax years and how these losses would have absorbed any basis they thought that might have otherwise had (i.e., before they even got to the current tax year and whether they could take these recent K-1 losses).

Comment: With all of the flowthrough entities that we prepare tax returns for, this is an incredibly important case. The bottom line is that if the client misunderstands the underlying tax law (or, more likely, we as tax preparers fail to interpret it correctly on their behalf), the client ends up suffering the consequences (or, decides to file a malpractice claim). For instance, a miscalculation of basis for a partner or S corp shareholder might mean that a K-1 loss is suspended where it should have been currently deducted. Or, the preparer does *not* understand the passive loss rules and decides that a loss must be currently suspended on **Form 8582**. Then, later on, after the statute of limitations for an amended return has passed, they learn that these prior losses could have been taken. But, then, it's too late. Yet, the taxpayer argues that this "wasted basis" should nevertheless still be available for taking more recent losses. Or, in the alternative, the preparers signs a return that is going to take these suspended losses on a prospective basis.

Comment: The bottom line is that even though the client never got a tax benefit from these losses, the statute for amending has now passed and they are gone forever. Furthermore, the tax basis of the taxpayer's interest in their partnership or S corp stock must still be correspondingly reduced.

Example: A preparer for the personal return of an LLC owner in a real estate partnership does *not* understand that "qualified real property indebtedness" can still be used under **Code §752(a)** as additional basis to take losses, even though this owner might never be personally liable for its payment (in a case where the LLC ultimately becomes incapable of repaying it). Yet, they fail to take current K-1 losses.

Example: Likewise, the preparer does *not* realize that *nonrecourse* debt (even if it's *not* "qualified real property indebtedness") still can serve as basis for distribution purposes, even if it's *not* "at-risk basis" for taking current K-1 losses. As a result, they treat a distribution as taxable when it should instead go against basis. Or, a current distribution is *not* made due to the failure to recognize that basis is otherwise available.

Example: A very common example is a real estate LLC that rents part of the building to the taxpayer's business (i.e., a "self-rental" situation), but they also have a number of other unrelated third-party lessees. The preparer erroneously treats *all* of the LLC's net rental income as nonpassive (i.e., under the recharacterization rules), instead of just the portion derived from the taxpayer's lease to his business (i.e., in which he materially participates). So, passive losses get suspended where they otherwise could have been deducted currently (i.e., given this available source of passive rental income from other third parties). Then, the discovery is made after the statute has run for amending the return. Yet, the preparer is considering still taking these losses on a prospective basis. Or, they insist that they should still have basis available in their LLC interest to at least take more recent losses.

Comment: Here, the D.C. Circuit held that both the IRS and the Tax Court were correct in finding that **Code§1367(a)(2)** requires an S corporation shareholder to reduce their basis by any losses that he is otherwise required to take into account under **Code §1366(a)(1)**. Thus, basis is reduced even if the shareholder does *not* actually claim the passthrough losses on his return. The "plain language of **Code §1366** and **Code §1367** supported the Tax Court's and IRS's interpretation of the Code." Accordingly, the taxpayer's current passthrough losses were limited because their basis was deemed to have already been reduced for prior year's losses that they had never deducted or received a tax benefit from. **(Code §1367; K-1 Basis)**

Code §1374 - Built-in Gains Tax:

☞C Corp Electing S Status Allowed Built-In Loss for Bonuses Pegged Against Cash Basis Receivables (PLR 200925005)

A cash basis personal service corporation (PSC) that elected S status was permitted to offset the potential built-in gain from the eventual collection of cash basis receivables with a built-in loss. Essentially, this took the form of a bonus for services rendered by its professional shareholder (as well as its nonshareholder employees) that was recorded on the books of the former C corporation during its last days of existence, but which was paid within 2½ months after becoming an S corp.

Comment: Key to the favorable result in this ruling was the fact that the taxpayer would pay to its shareholder/employees within the first *two and one-half months* of the recognition period, all salary and wage expenses that were related to the production of accounts receivable that were outstanding as of the effective date of the S election.

Comment: As to the payments made to any *nonshareholder* employees, these could be made at any point during the 10-year built-in gains period (i.e., 5 years today, but the *same* time frame as that for any other accounts payable or other unpaid payroll expenses).

Background: **Code §1374(d)(4)** provides that any loss recognized on a disposition of an asset during the

recognition period is recognized built-in loss to the extent the S corporation establishes that it held the asset on the first day of the recognition period and such loss does *not* exceed the excess of (i) the adjusted basis of such asset as of the beginning of such first taxable year, over (ii) the fair market value of such asset as of such time. **Code §1374(d)(5)(B)** provides that any item of deduction properly taken into account during the recognition period but attributable to periods before the first day of the recognition period is recognized built-in loss for the taxable year for which it is allowable as a deduction. **Code §1374(d)(5)(C)** provides that an S corporation's net unrealized built-in gain is properly adjusted for items of income and deduction that would be recognized built-in gain or loss if taken into account during the recognition period. **Reg. §1.1374-4(b)(2)** provides, in relevant part, that "any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction against gross income before the beginning of the recognition period to an accrual method taxpayer." **Reg. §1.1374-4(c)** limits the treatment under **Reg. §1.1374-4(b)(2)** of items of deduction properly taken into account during the recognition period as recognized built-in loss. The limitation of **Reg. §1.1374-4(c)** applies to items of deduction constituting payments to related parties and any amount properly deducted during the recognition period under **Code §404(a)(5)** (i.e., relating to payments for deferred compensation). **Reg. §1.1374-4(c)(1)** (relating to regular compensation such as bonuses paid out of receivables) provides that any payment to a related party properly deducted in the recognition period under **Code §267(a)(2)** will be deductible as recognized built-in loss only if: (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is paid: (A) within the first two and one-half months of the recognition period; or (B) to a related party owning less than five percent, by voting power and value, of the corporation's stock, both as of the beginning of the recognition period and when the amount is paid. Meanwhile, **Reg. §1.1374-4(c)(2)** (relating to deferred compensation payments) provides that any amount properly deducted in the recognition period under **Code §404(a)(5)** will be deductible as recognized built-in loss to the extent: (i) all events have occurred that establish the fact of the liability to pay the amount, and the exact amount of the liability can be determined, as of the beginning of the recognition period; and (ii) the amount is *not* paid to a related party to which **Code §267(a)(2)** applies. **(Code §1374; BIG Tax)**

> **Comment:** This is one of the prime considerations when a PSC decides to elect S status. Namely, if a cash basis accounts receivable is subject to the built-in gains tax, the rate could effectively go as high as 57.5% (i.e., 35% x $100 of BIG + (35% x ($100 - 35 BIG tax)). Whereas, if S election had never been made, then the PSC would have simply paid out these receivables as collected with the only tax being that paid at the shareholder/employee's marginal tax rate (i.e., at most, 35%). And, the IRS has won at least two cases where the planning outlined above was not properly consummated and the cash basis receivables subsequently collected by the S corp were subject to the built-in gains tax. **Tax impact now with flat C corp rate of 21% would be 50.23% ((21% x $100 of BIG) + (37% x ($100 - 21 BIG tax))**.

Code §1411 - 3.8% Medicare Surtax:

☞**Making S Election to Save on 3.8% Medicare Surtax**

A doctor owned 100% of a C corporation which operated a surgery center. Contemplating retirement, he was offer a million dollar plus incentive to sell the assets of his business. But, as the sole owner of a non-flowthrough entity, his material participation over the many years counting for nothing as far as demonstrating that this was a "nonpassive entity." Instead of consummating the sale in late 2022, upon the advice of his tax professional, he delay the sale until early 2023. In the meantime, he made an prospective S corporation election on **Form 2553** to be effective as on 1/1/2023. There would be "double taxation" whether he did a sale of the former C corporation assets (i.e., under **Code §336** and **Code §331**, or having the "built-in gains" tax provision under **Code §1374** otherwise apply.Nevertheless, with being an S corporation as of the date of the sale, his material participation meant that this was no longer a passive activity. Therefore, the **Code §1411** Medicare surtax (i.e., as shown on **Form 8960**) did *not* apply. **(Code §1411; Medicare Surtax)**

> **Comment:** This rather simple planning tip saved over $180,000 with regard to the recent sale of this doctor's surgery center.

Code §3402 - Withholding Taxes:

☞**S Corp Owner Not Liable for Failure to Deposit and Pay Penalties on "Non-Wage Advances" (*Ryan, Inc.*, TC Summary Opinion 2010-18 (2/23/2010))**

The Tax Court has concluded that an S corporation, solely owned and operated by one individual, was *not* liable for penalties for a failure to deposit and pay payroll taxes where its CPA advised that it could simply have an "annual payroll" while simultaneously transferring advances to the owner's personal account throughout the year that would *not* be treated as wages. In rendering this advice, the CPA had incorrectly advised that these "advances" would *not* constitute wages at the time of transfer, so long as "the owner had an obligation to repay the advances." At the end of the year, the owner would then satisfied his repayment obligation when the corporation credited the advances made with the compensation due to the owner for his services, resulting in a net payment of zero. **(Code§3402; Withholding Taxes)**

> **Comment:** In reaching its conclusion, the Tax Court turned aside the IRS's argument that it was unreasonable for the taxpayer to rely on the CPA's advice "because he did *not* base his opinion on any specific Code provision (i.e., he simply consulted an IRS publication), and that the advice was wrong." The Court noted that while the taxpayer "may have been ill- advised, that was *not* the standard for a reasonable cause determination."

> **Comment:** Even though the taxpayer here was let off the hook (due to his reliance on his CPA) for only issuing one paycheck for the entire tax year, while simultaneously making distributions throughout the year, we should advise clients in similar situations to take out at least some of the S corp's profits throughout the year as a "reasonable salary" (and, *not* to take all of the monies as "salary advances" or simply distributions with only one paycheck dedicated solely to withholding taxes at yearend).

ESTATES, GIFTS & TRUSTS:

Miscellaneous:

☞**2023 Increase to Unified Credit Equivalent (Rev. Proc. 2022-38)**
With regard to transfer tax (i.e., gifts or estates), the basic exclusion amount (i.e., unified credit equivalent) will now be $12,920,000 (up from $12,060,000 in 2022). **(Code §2031 & 2501; Unified Credit Equivalent)**

> **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).

☞**2023 Increase to Gift Tax Exclusion (Rev. Proc. 2022-38)**
The annual exclusion for gifts increases to $17,000 for calendar year 2023, up from $16,000 for 2022. **(Code §2501; Gift Tax Exclusion)**

> **Comment:** If an election was made to "gift split" a transfer (i.e., by properly filing **Form 709**), then $34,000 could be given by a married couple without any need to use the unified credit equivalent.

Code §170 - Charitable Contributions:

☞**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 §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)**

Code §2031 - Definition of Gross Estate:

☞**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)**

Code §2032A - Valuation of Certain Farm, etc. Real Property:

☞**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 adjusted gross 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 §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**.

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:

☞ **SECURE Act 2.0 Retirement Bill**

NOTE: REFER TO SEPARATE SECURE ACT SUPPLEMENT FOR COMPREHENSIVE COVERAGE.

☞**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:

☞**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 §105 - Health Reimbursement Arrangements:

☞**Regs for Health Reimbursement Arrangements Finalized (TD 9867)**

The IRS, along with the Departments of Labor (DOL) and Health and Human Services (HHS), has issued final rules that allow integrating health reimbursement arrangements (HRAs) and other account-based group health plans with individual health insurance coverage or Medicare, if certain conditions are satisfied (i.e., individual coverage HRA). The final rules also set forth conditions under which certain HRAs and other account-based group health plans will be recognized as "limited excepted benefits."

Comment: Although we might be experts in general tax law areas, we might not work intensely in the fringe benefit or retirement plan area on a day-to-day basis. Nevertheless, there is no reason why we cannot have some awareness when important changes are made and at least know to seek out additional input for our clients' planning needs.

Comment: These regs apply to tax years beginning after 12/31/19.

Background - Health Reimbursement Arrangements (HRAs): An "account-based group health plan" is an employer-provided group health plan that provides for reimbursement of expenses for medical care, subject to a maximum fixed-dollar amount of reimbursements for a period (e.g., a calendar year). An HRA is a type of account-based group health plan funded solely by employer contributions (i.e., with no salary reduction contributions or other contributions by employees) that reimburses an employee solely for medical care expenses incurred by the employee, or the employee's spouse, dependents, and children who, as of the end of the tax year, have *not* attained age 27, up to a maximum dollar amount for a coverage period. The reimbursements under these types of arrangements are excludible from the employee's income and wages for Federal income tax and employment tax purposes. And, amounts that remain in the HRA at the end of the year often may be used to reimburse medical care expenses incurred in later years, depending on the terms of the HRA. Account-based group health plans also include other arrangements, for example, health flexible spending arrangements (health FSAs).

Background - Affordable Care Act (ACA): The **Affordable Care Act** added **Code §9815(a)(1)** to incorporate the provisions of **Part A of Title XXVII of the Public Health Service Act (PHSA)** into ERISA and the Code, and make them applicable to group health plans and to health insurance issuers providing health insurance coverage in connection with group health plans. Under **Code §4980D**, an excise tax is imposed on failures to meet these requirements.

Among the ACA provisions applicable to group health plans are the "annual dollar limit prohibition" (i.e., annual limit), which prohibits a group health plan (or, a health insurance issuer offering group health insurance coverage) from establishing *any* annual limit on the dollar amount of benefits for *any* individual. (**PHSA §2711**) Also applicable are "preventative services requirements," which require non-grandfathered group health plans (or, health insurance issuers offering group health plans) to provide certain preventative services without imposing any cost-sharing requirements for the services. (**PHSA §2713**)

Under the ACA, the **Health Insurance Portability and Accountability Act**, and other statutes, both the Code and ERISA subject group health plans to a variety of requirements. However, these requirements generally do *not* apply to "excepted benefits," including limited excepted benefits that:

a. Are provided under a separate policy, certificate, or contract of insurance, or

b. Are otherwise *not* an integral part of the plan. (**Code §9831(c)(1)**)

Specifically, the benefits offered separately from a group health plan that may be "excepted" are:

1. Limited scope vision and dental benefits (**Code §9832(c)(2)(A)**);

2. Benefits for long-term care, nursing home care, home health care, or community-based care, or any combination of those benefits (**Code §9832(c)(2)(B)**); and

3. Other similar, limited benefits as specified in the regs. (**Code §9832(c)(2)(C)**)

2018 Proposed Regs: The Departments issued proposed regs that would allow an individual coverage HRA to be integrated with individual health insurance coverage or Medicare. The combined coverage would allow the HRA to satisfy the annual limit and preventative service requirements, under certain circumstances. The proposed regs also proposed expanding the definition of "limited excepted benefits" under **Code §9832(c)(2)**, to

recognize certain excepted benefit HRAs. (**Prop. Reg. §54.9831-1**)

In addition, the proposed regs included rules on premium tax credit (PTC) eligibility for individuals covered under an individual coverage HRA integrated with individual health insurance coverage. An individual is eligible for the PTC for a month if the individual meets various requirements (i.e., a "coverage month"). Among other things, under **Code §36B(c)(2)**, a month is *not* considered to be a "coverage month" for an individual if either:

1. The individual is eligible coverage under an eligible employer-sponsored plan and the coverage is "affordable and provides minimum value" (MV); or

2. The individual is enrolled in an "eligible employer-sponsored plan," even if the coverage is *not* affordable or does *not* provide MV.

An "eligible employer-sponsored plan" includes coverage under an insured or self-insured group health plan and is "minimum essential coverage" (MEC) unless it consists solely of "excepted benefits."

The proposed regs provided that an employee who is offered, but opts out of, an HRA integrated with individual health insurance coverage, and an individual who is offered such an HRA because of a relationship to the employee (i.e., a "related HRA individual"), are eligible for MEC under an "eligible employer sponsored plan" for any month the HRA is "affordable and provides MV." As a result, these individuals would *not* be eligible for the PTC for their Exchange coverage for months the HRA is affordable and provides MV. (**Prop. Reg. §1.36B-2**)

The proposed regs also addressed the circumstances in which an HRA is considered to provide MV and would clarify the ways in which the generally applicable employer-sponsored coverage PTC eligibility rules apply to HRAs integrated with individual health insurance coverage.

In addition, the DOL proposed a clarification to provide plan sponsors with assurance that the individual health insurance coverage premiums reimbursed by an HRA and other account-based health plans or a qualified small employer health reimbursement arrangement (QSEHRA) does *not* become part of an ERISA plan, provided certain conditions are met.

HHS proposed regs that provided a special enrollment period in the individual market for individuals who gain access to an HRA and other account-based group health plans integrated with individual health insurance coverage or who are provided a QSEHRA.

2019 Final Regs: The various Departments mentioned above have now finalized the proposed regs. The final regs largely adopt the proposed regs with some modifications. Like the proposed regs, the final regs allow integration of individual HRAs with individual health insurance coverage and Medicare. (**Reg. §54.9802-4**) As a result, an employer that does *not* provide group health insurance to its employees may offer an individual HRA that will satisfy the requirements for MEC as long as certain conditions are met.

Generally, an HRA must require the participant (and, any dependents) to be enrolled in individual health insurance that is subject to, and complies with, the prohibition on annual payout limits and required preventative services rules. (**Reg. §54.9802-4(c)(i)**) In addition, the HRA must provide that it will *not* reimburse medical expenses incurred by the participant *after* the individual health coverage ceases. (**Reg. §54.9802-4(c)(ii)**) The HRA plan sponsor must verify the participant's individual health insurance coverage with each request for reimbursement and can rely on substantiation provided by the participant (**Reg. §54.9802-4(c)(5)**)

Furthermore, a plan sponsor may *not* offer a choice between an individual coverage HRA and a traditional group health plan to any participant (or, dependent). (**Reg. §54.9802-4(c)(2)**) Also, an individual coverage HRA must be offered on the *same* terms to *all* participants in the *same* class. The final regs add "restriction class size" but allow additional class types. (**Reg. §54.9802-4(c)(3)**) However, there may be a variation in the terms due to the number of participant's dependents covered (**Reg. §54.9802-4(c)(3)(A)**) or the participant's age. (**Reg. §54.9802-4(c)(3)(B)**)

Under the final regs, a participant must be allowed to opt out of coverage *before* the beginning of the plan year. (**Reg. §54.9802-4(c)(4)**)

The final regs retain the proposed rule that an employee and a related HRA individual are *not* eligible for the PTC any month the employee is offered an individual coverage HRA that is affordable and offers MV, even if the employee opts out of the arrangement. (**Reg. §1.36B-2**)

The final regs also define "essential health benefits" and how HRAs can be used once they are integrated with individual health insurance. (**Reg. §54.9815-2711**)

Comment: The IRS has also released **Notice 2019-45** expands upon previous guidance (**Notice 2004-23**, **Notice 2004-50** and **Notice 2013-57**) by providing an appendix with a limited list of additional "preventive care services" and items for certain "chronic conditions" that may be treated as preventive care for purposes of **Code § 223(c)(2)(C)**. These additional services and items are treated as "preventive" only when prescribed to treat an individual "diagnosed with the specified chronic condition," and only when prescribed "for the purpose of preventing the exacerbation of the chronic condition or the development of a secondary condition."

Effective Dates: The regs are effective on August 19, 2019. They generally apply for plan years beginning *on or after* January 1, 2020. However, the final rules under **Code §36B** apply for taxable years beginning *on or after* January 1, 2020, and the final rules providing a new special enrollment period in the individual market apply January 1, 2020. **(Code §105; HRAs)**

Code §125 - Cafeteria Plans:

☞Unused Transportation Benefits Could Not Be Transferred Over to FSA (Info. Ltr. 2022-0002)

The IRS has confirmed through a private letter ruling that unused transportation benefits that this employee had previously received could *not* be transferred over to a health FSA. In this instance, the employee received pre-tax parking benefits through his employer but was now permanently working from his home because of the coronavirus pandemic. As a result, he no longer needed the benefits and wanted to transfer the unused funds to his health flexible spending arrangement. **(Code §125; FSA)**

Comment: This same result has been seen in several cases where an employee leaves their job and requests a refund of monies that they have previously set aside in their flexible spending account. It basically becomes a "nonrefundable deposit" that cannot be returned to the employee. The same is true where significant amounts were set aside in a **Code §129** "dependent care assistance" program administered by an employer and the employee finds themselves now caring for the child at home when the daycare center was closed during the coronavirus pandemic.

☞Death of Ex-Spouse Was Not Cafeteria Plan "Change in Status" (Info. Ltr. 2019-0013)

This IRS "information letter" concluded that the death of a *former* spouse is *not* to be treated as a "change in status" for **Code §125** cafeteria plan purposes. Therefore, the surviving ex-spouse, who was providing health benefits via a cafeteria plan to the decedent because of a court order, was *not* permitted to change plan benefits in the middle of the plan year (i.e., they had to effectuate the change for the following plan year).

Background: A **Code §125** cafeteria plan is a plan where no amount is includible in the gross income of a participant in the plan solely because the participant can choose among the benefits they receive from the plan. (**Code §125(a)**) Generally, a **Code §125** cafeteria plan requires that an employee elect benefits *before* the beginning of the plan year (i.e., election period). (**Prop. Reg. §1.125-2(a)**) As a result, the employee cannot change the election during the plan year unless a "change in status" occurs. (**Reg. §1.125-4(c)**) One event that is considered to be a "change in status" is when there is a change in the number of an employee's dependents. (**Reg. §1.125-4(c)(2)(ii)**) In general, a "dependent" means a qualifying child or qualifying relative. (**Code §152(a)**)

A former spouse is *not* a "dependent" as defined under **Code §152**. Therefore, as the IRS points out in this guidance, the death of a former spouse does *not* change the number of an employee's dependents and is *not* a change in status under the regs. On the other hand, **Reg. §1.125-4(d)(1)** does provide that a cafeteria plan may treat certain court orders requiring health coverage for an employee's child as a change in status. But, **Reg. §1.125-4(d)(1)** does *not* include as a change in status a situation in which the death of a *former* spouse effectively terminates the requirement to provide health coverage under a court order.

IRS Information Letter: In this instance, an employee specifically asked whether an election under a **Code §125** cafeteria plan, made pursuant to a court order to provide health coverage to his ex-spouse, entered in connection with the employee's divorce, can be changed upon the death of the former spouse. In response, based on the analysis above, this is *not* a "change in status." Therefore, the employee cannot change the election during the middle of a plan year. Instead, the employee must wait until the election period before the beginning of the *next* plan year to make any changes. **(Code §125; Cafeteria Plan)**

Comment: The employee here wanted to reduce his monthly premium amount by only having to cover himself for the remainder of the tax year in which his ex-spouse died, but was denied. But, the death or divorce of a current spouse would have served as a "change in status" which would have allowed an adjustment in enrollment in the cafeteria plan.

Code §132 - Employer-Provided Fringe Benefits:

☞**Service Releases Fringe Benefit Guide (IRS Pub. 15-B)**

The IRS has released the 2023 final version of its **Publication 15-B (The Employer's Tax Guide to Fringe Benefits)**. The "What's New" section of the publication includes information on the 2023 business mileage rate under the "cents-per-mile rule," the monthly exclusion for qualified parking and commuter transportation benefits, and the contribution limit on a health flexible spending arrangement (FSA). There is also a table (on page 6) of the publication that summarizes the differences in the treatment of various fringe benefits for federal income tax withholding (FITW), Social Security and Medicare (FICA), and federal unemployment tax (FUTA) purposes. For example, payments from an employer's adoption assistance plan that meet certain requirements are *not* subject to FITW. However, the payments are subject to FICA and FUTA tax.

Qualified Parking Exclusion and Commuter Transportation Benefit: The monthly exclusion for both qualified parking and for commuter highway vehicle transportation and transit passes is $300 in 2023.

Contribution Limits for Health Flexible Spending Arrangements: A cafeteria plan may *not* allow employees to request salary reduction contributions to health FSAs greater than $3,050 in 2023. Employers must generally determine the value of noncash fringe benefits no later than January 31st of the next year. Before January 31, employers may "reasonably estimate" the value of the fringe benefits for purposes of withholding and depositing on time. Employers may be subject to a penalty if they underestimate the value of the fringe benefits and deposit less than the amount that they would have had to deposit if the applicable taxes had been withheld. On the other hand, if employers overestimate the value of the fringe benefit and over deposit, they may either claim a refund or have the overpayment applied to their next Form 941. **(Misc.; Fringe Benefits)**

Comment: IRS Pub. 15-B supplements **IRS Pub. 15, (Circular E) (Employer's Tax Guide)**, and **IRS Pub. 15-A (Employer's Supplemental Tax Guide)**.

Code §223 - Health Savings Accounts:

☞**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.

Notes:

EMPLOYMENT TAXES:

Miscellaneous:

☞**IRS Voluntary Certification Program for PEOs (Rev. Proc. 2023-18)**
The Service has established a voluntary certification program for third-party payroll agents. Those that successfully complete the program would qualify as "certified professional employer organizations." Furthermore, those companies that use CPEOs would *not* be liable for payroll taxes or withholding. Instead, the CPEO would be solely responsible for paying the taxes, filing the employment tax returns and making the tax deposits and payments to worksite employees. Complete details on certification are set out in the revenue procedure. (Code §1401; CPEOs)

☞**Projected $168,600 FICA Cap for 2024**
According to the White House budget forecast, the Social Security wage base is projected to increase from $160,200 to $168,600 for 2024. Meanwhile, projections for future years are pegged at $177,900 for 2025, $185,100 for 2026 and $192,300 for 2027. **(Code §1401; FICA Cap)**

> **Comment:** The final number, based on national average-wage-index growth, will be released in mid-October.

☞**Social Security Wage Base Soaring to $160,200 for 2023 (SSA Release 10/13/22)**
The Social Security Administration (SSA) recently announced that the maximum earnings subject to the Social Security component of the FICA tax will increase from $147,000 to $160,200 for 2023. As a result, the maximum Social Security tax that employers and employees will each pay in 2023 will be $9,932.40 ($160,200 x 6.2%). Meanwhile, the Medicare component remains on 1.45% of all earned income, In addition, individuals with earned income of more than $200,000 ($250,000 for married couples filing jointly, $125,000 for married filing separately) will pay an additional 0.9% in Medicare taxes. And based on the increase in the Consumer Price Index (CPI-W) from the third quarter of 2021 through the third quarter of 2022, approximately 70 million Social Security and Supplemental Security Income (SSI) beneficiaries will receive a 8.7% cost-of-living adjustment (COLA) for 2023.

> **Comment:** Other 2023 COLAs announced by the SSA are available on their **website**.

> **Comment:** The **Code §1411** 3.8% and .9% Medicare surtaxes (i.e., as shown on **Form 8960** and **Form 8959** respectively) have *not* been indexed for inflation since they were first introduced into the tax law for the 2014 tax year.

Code §1402 - Self-Employment Taxes:

☞**When Short-term Rental Income Is Subject to S/E Tax (CCA 202151005)**
This IRS Chief Counsel Advice outlines, in two examples, when income from short-term rentals is included in self-employment income.

> **Comment:** Take a look at **Form 1040, Schedule 1, Line 8k** which now has a specific listing for "personal property rentals" that would *not* be subject to self-employment tax.

Net Earnings from Self-employment: **Code §1401(a)** imposes a tax on an individual's net earnings self-employment (NESE). However, under **Code §1402(a)(1)**, "net rental income," generally is *not* included in NESE, unless:

1. The income is received by a "real estate dealer," or

2. The rent includes "substantial" (i.e., "significant personal") services provided to the occupant for the occupants' convenience.

Examples of rentals where "substantial services" are rendered for the occupants' convenience include hotels, motels, boarding houses, and BnB's. Sometimes, warehouses and storage garages might be included as well, depending on the circumstances. (**Reg. §1.1402(a)-4(c)(2)**)

Rental Activities: A rental activity is automatically *not* treated as a passive activity if the average period of customer use of the property is *seven days or less*. In addition, a rental activity (which is treated instead as a trade or business) would *not* be considered passive if the taxpayer "materially participates" in the activity. (**Code §469(a)(7)**)

> **Comment:** But keep in mind that, under **Reg. §1.469-1T(d)(1)**, characterizing items of income or deduction as passive activity income or deductions only affects the treatment of those items for purposes of the passive activity loss rules.

Example #1: An individual, who is *not* a real estate dealer, has a business renting a fully furnished vacation property via an online rental marketplace (e.g., AirBnB or VRBO). The individual provides daily maid service, access to dedicated Wi-Fi, beach and recreational equipment for occupants' use during their stay and prepaid vouchers for ride-share services between the property and the nearest business district. For the year at issue, customers used the vacation property on average for seven days. As a result, the activity is *not* automatically considered a "rental activity" for purposes of the passive activity loss rules in **Code §469**. Instead, it is "elevated" to the same status as any other trade or business activity would be under the PAL rules.

In this example, Chief Counsel notes that the taxpayer provides services for occupants that:

1. Are *not* clearly required to maintain the space in a condition for occupancy, and

2. Are of such a "substantial nature" that the compensation for those services "constitutes a material portion" of the overall rent paid.

Therefore, the net rental income in this instance is included in NESE (and, must be reported on **Schedule C** as a business and subject to self-employment tax on Schedule S/E).

Example #2: An individual, who is *not* a real estate dealer, has a business renting a fully-furnished room and bathroom in their dwelling via an online rental marketplace. Renters only have access to the common areas of the home to enter and exit the room and bathroom, but they do *not* have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay. For the year at issue, the average period of customer use of the vacation property is seven days and the taxpayer materially participates in the activity. Therefore, the activity is *not* automatically a passive activity for purposes of the passive activity loss rules. Moreover, in this situation, the taxpayer's net income from renting living quarters is excluded from NESE because only minimal services are rendered to the occupants. The taxpayer cleans and maintains the property so that it remains suitable for occupancy. Therefore, these services are *not* furnished primarily for the occupants' convenience. (**Code §1402; S/E Tax)**

☞**Final Regs Issued on S/E Tax for Partners in Partnership Owning SMLLCs (TD 9869)**

The IRS has issued final regs that provide that partners in a partnership that owns a disregarded entity are *not* employees of the disregarded entity for employment tax purposes and are, instead, subject to self-employment tax based on their share of income from that partnership (i.e., K-1, Boxes 1 and 4, as totaled in Box 14). (**Code §1402; S/E Tax)**

Code §3121 - Independent Contractor v. Employees:

☞**IRS Guidance on Classification of Common Law Employees**

The IRS Office of Federal, State, and Local Government recently hosted a webinar offering guidance on which workers are or are *not* considered employees for classification purposes under **Code §3121(d)(2)** using the

application of common law standards and factoring the circumstances surrounding the work performed (i.e., the "20-factor rules").

Comment: Using Uber or Lyft as examples, how would you treat these workers?

Under common law rules, whether an individual is an employee or an independent contractor is determined by the relationship of the worker with regard to the business, and if the business can direct or control how the worker performs a task.

The IRS considers several aspects of the relationship between parties that can inform how a worker is classified, such as:

(1) The substance of the relationship, rather than its label;

(2) Whether a worker receives benefits (e.g., health insurance, pension plan, vacation/sick pay);

(3) The permanency of the relationship; and

(4) The extent to which a worker's services are a key aspect of the regular business of the company.

Behavioral Control: A business has what the IRS labels as "behavioral control" of an employee if it can place restrictions on what equipment can be used, where supplies can be purchased, or protocol to follow. Formal training is also indicative of an employee relationship.

Risk of Loss: An independent contractor can make a profit or loss and are paid a flat fee or a contract price, while employees do *not* incur such risk and are paid a regular wage.

Independent Contractors: Independent contractors are, generally (i.e., there is no formal definition), self-employed individuals who have been contracted to perform services for a taxpayer. This would include, for example, doctors, veterinarians, and auctioneers working in an independent trade, business, or profession in which services are offered to the public. Because independent contractors control the means and methods of how to accomplish an assigned task or project, they are *not* classified as employees.

Statutory Non-employees: "Statutory non-employees" are specifically excluded from the definition of "employee" for tax purposes. There are three categories of statutory non-employees:

Direct sellers: Individuals engaged in selling consumer products in the home or place of business other than in a permanent retail establishment (including newspaper or shopping news distributors);

Qualified real estate agents: Individuals engaged in appraisal activities for real estate sales, with at least 90% of earned income coming from commissions on sales or other outputs; and

Specified companion sitters: Individuals who furnish personal attendants, companionship, household care services to children, elderly, and/or disabled persons.

Statutory Employees: Individuals falling under one of the following categories are considered employees (at least for employment tax purposes):

Agent drivers: Individuals who distribute beverages other than milk, meat, vegetables, fruit, or bakery products, or who pick up and deliver laundry or dry cleaning.

Full-time life insurance sales agents: Individuals whose principal business activity is selling insurance or annuity contracts, or both.

At-home contractors: Individuals who work at home on materials or goods that must be returned to a

customer.

Full-time traveling sales agents: Individuals who work on someone's behalf and turns in orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments.

<u>Comment</u>: Statutory employees are treated as employees for Social Security and Medicare tax purposes. But they file a **Schedule C** with their personal return as if they are self-employed. Unlike regular employees, who cannot deduct their unreimbursed expenses on **Schedule A** (i.e., since 2% miscellaneous deductions on **<u>Form 2106</u>** were eliminated for most taxpayers), statutory employees can instead deduct business costs on **Schedule C**. Furthermore, they can potentially qualify for the **Code §199A** 20% deduction on "qualified business income."

Corporate Officers: Officers of a corporation are employees unless *both* of the following situations apply:

(1) The officer does *not* perform any services or performs only "minor services;" and

(2) The officer is *not* entitled to receive (directory or indirectly) any remuneration.

<u>Comment</u>: Services are "minor or nominal" depending on the character of the service, the frequency and duration of performance, and the how important such services are to the conduct of the corporation's business.

Governmental Employees: <u>Code §3401(c)</u> provides that an elected or official of a state or local government is an employee. The same is true of public officers that have been elected or appointed.

<u>Form SS-8</u>: <u>Form SS-8</u> can be filed with the IRS by either the worker or the entity for which the worker performs services for an official will receive a binding response as to whether the worker is an employee.

<u>Voluntary Classification Program</u>: The **Voluntary Classification Settlement Program (VCSP)** allows taxpayers that treat its workers as independent contractors or other non-employees to instead reclassify them as employees. However, an eligible taxpayer wishing to do this "reclassification" must have filed **Form 1099-NEC** for each applicable worker it has treated as a non-employee (i.e., independent contractor) for the previous three years. To apply, a taxpayer must submit a **Form 8952** and enter into a closing agreement with the IRS. **(<u>Code §3121</u>; Independent Contractors)**

<u>Comment</u>: Business clients should be advised to use **Form 1099-NEC (Non-Employee Compensation)** by 1/31/2022 to report compensation of $600 or more to non-employees (i.e., instead of **Form 1099-MISC**). Meanwhile, such payments could be subject to backup withholding in certain instances if the payee has failed to provide a Taxpayer Identification Number to the payer or if the IRS notifies the payer that the payee provided a TIN (e.g., Social Security, employer identification, individual taxpayer identification and adoption taxpayer identification) that does *not* match their name in IRS records.

<u>Comment</u>: For 2021 tax returns, there is no automatic 30-day extension to file **Form 1099-NEC**, although a filing extension may be available "under certain hardship conditions."

☞**<u>Home Health Care Nurses Treated as Employees</u> (<u>*Pediatric Impressions Home Health, Inc.*, T.C. Memo 2022-35 (4/12/2022)</u>)**

The Tax Court has confirmed the IRS' determination that the taxpayer failed to classify correctly approximately 99 individuals as employees during tax years 2016-2018 (i.e., the company had instead been treating them as independent contractors). As a result, the company was liable for federal employment taxes, additions to tax, failure-to-deposit penalties, and accuracy-related penalties. The company was involved in the business of providing at-home private duty nursing services to children with special needs. They hired nurses to perform services on its behalf and set the nurses' work schedules, which varied for each nurse. Among the "common law 20-factor tests," the Court found that the key indications demonstrating that they were employees included: (1) the degree of control

exercised by the alleged employer; (2) the degree to which the worker's opportunity for profit or loss is determined by the alleged employer; (3) the extent of the relative investments of the worker and the alleged employer; (4) the permanency of the relationship; and (5) the skill and initiative required in performing the job. **(Code §3121(d)(2); Independent Contractors)**

> **Comment:** This can certainly be an area of confusion where the IRS has listed among the various "Statutory Non-employees" the category of "Specified Companion Sitters" which would include "individuals who furnish personal attendants, companionship, household care services to children, elderly, and/or disabled persons." The difference in this situation was probably due to the fact that these professionals were skilled nurse and *not* just "companion sitters."

Code §3401 - Withholding Taxes:

☞**In-home Care Payments Subject to Employment Taxes (CCA 202243009)**
Given that an employment relationship exists, in-home care payments to service providers, whether related or not, should generally be treated as remuneration for services rendered and therefore subject to *both* income and FICA and FUTA taxes absent an applicable exception. In this Chief Counsel Advice (CCA) it was noted that **Notice 2014-7** stated certain in-home care payments to service providers, including parents who receive payments from the Medicaid waiver program for the care of their child, are treated as "difficulty-of-care payments" under **Code §131** and therefore *not* includible in gross income for federal income tax purposes. However, the Notice did *not* address the FICA or FUTA tax treatment of these in-home care payments. The CCA concludes that these payments are still generally subject to FICA and FUTA taxes unless an exception applies. **(Code §3401; In-home Health Care)**

Code §6672 - Failure to File Tax Return or Pay Tax:

☞ **Part-time Bookkeeper Liable for Employer's Unpaid Payroll Taxes (*Kazmi*, TC Memo. 2022-13 (3/1/2022))**
This employee ending up owing the 100% trust fund penalty for "willful failure" to deposit the company's withheld payroll taxes to the government. He was an hourly employee of a doctor's office who took care of the business's payroll. And, although he knew that taxes withheld from workers' paychecks were *not* remitted to the IRS, he claimed that he should *not* be treated as a "responsible person" who "willfully failed" to pay over the taxes. His arguments included that he was *not* an officer or director, he had no ownership stake in the business, he had no check-signing authority, and he could *not* make payments on the company's behalf. Nevertheless, the Tax Court agreed with the IRS, holding that its collections settlement officer acted properly and did *not* abuse their discretion. **(Code §6672; Trust Fund Penalty)**

TAX-EXEMPT ENTITIES:

Code §170 - Tax-exemption:

☞**IRS Guide on Gambling Activities by Tax-Exempt Entities Available**
The IRS has a useful guide entitled **"Tax-Exempt Organizations and Gaming."** It is intended for tax-exempt entities that seek to raise funds through "casino nights" and other gambling related activities. Most importantly, it advises such entities on avoiding the possible loss of their tax-exempt status especially where there is an excess of such activities (i.e., since these receipts would be considered "unrelated business income"). Also covered in this guide are "excise and payroll tax issues, withholding obligations, helpful recordkeeping tips and the rules for reported winnings." **(Code §501(c)(3);Tax-Exempt Entities)**

Code §512 - Unrelated Business Income Tax:

☞**IRS Audit Focus on UBIT**

The IRS is increasing its focus on tax-exempt groups in the upcoming 2023 tax year. A key issue will be the investment and non-member income of social clubs. Under **Code §501(b)**, for a social club to obtain and keep their exemption, no more than 15% of its gross receipts can come from non-members, and the aggregate sum of receipts from investment income and non-members is *not* permitted to exceed 35% of the club's overall receipts. The IRS recently revoked the exemption of a club whose income was derived mostly from the public and *not* from members. **(Code §501(b); UBIT)**

☞**Charities Soliciting Advertising Income and Impact of UBTI Rules (IRS Issue Snapshot)**

Under **Code §512(a)**, an exempt organization's income from the conduct of a trade or business can nevertheless still be treated as being "substantially related to its exempt purpose" which avoids the entity being subject to the "unrelated business taxable income" (UBTI) rules. For example, when an exempt organization has its own magazine, newsletter, or other publication (e.g., AARP monthly magazine), some or all of its income from selling advertising will *not* be considered UBTI "if the editorial content of the publication is substantially related to the organization's exempt purpose." Royalty income is also excluded from UBTI. However, an issue may arise when an exempt organization contracts with a third-party to publish their magazine or newsletter and then reports the advertising income as royalties. According to this IRS **"Issue Snapshot,"** whether advertising income is properly treated as royalties "is determined from all the facts and circumstances." **(Code §512; UBTI)**

Notes:

ADMINISTRATIVE & PROCEDURAL MATTERS:

Miscellaneous Items:

☞**IRS 2023 Dirty Dozen Campaign Begins with ERC Claims (IR 2023-49)**

For the start of the Service's annual Dirty Dozen list of tax scams, the IRS has chosen to emphasize Employee Retention Credits. This stems from the blatant attempts by promoters to con ineligible businesses to claim the credit and includes schemes from promoters who have been using radio ads and the internet promising refunds involving ERCs. These promotions can be based on inaccurate information related to eligibility for and computation of the credit. The **IRS Office of Professional Responsibility** sent a special bulletin (**OPR Issue 2023-02**) to tax professionals on 3/7/23 outlining core responsibilities for ERC claims under **Circular 230**. The IRS continues to step up enforcement action involving these ERC claims and employers considering filing for these claims, reminding them that they are ultimately responsible for the accuracy of the information on their tax return. **(Misc.; ERC)**

> **Comment:** According to the IRS, the "**Dirty Dozen**" is an annual list put out by the Service of the 12 scams and schemes that put taxpayers and the tax professional community at risk of losing money, personal data and more. Some items on the list are new, and some make a return visit. While the list is *not* a legal document or a formal listing of agency enforcement priorities, it is intended to alert taxpayers, businesses and tax preparers about scams at large.

> **Comment:** **IR-2023-67** also contains a warning for taxpayers to beware of promoters peddling bogus tax schemes aimed at reducing taxes or avoiding them altogether. According to the IRS, "These schemes can take many shapes, ranging from abusive deals involving syndicated conservation easements and micro-captive insurance arrangements. They can also involve an international component, such as hiding cash and digital assets offshore or using Maltese foreign individual retirement accounts or foreign captive insurance." More information regarding these schemes can be found in **IR-2023-67**

☞**New Rule for Corporate Reporting of Beneficial Ownership (RIN 1506-AB49)**

Entities doing business in the U.S. will now be required to disclose who owns or controls them, under a final rule on beneficial ownership issued by the Treasury Department. This stipulation stems from a 2019-passed law targeting corruption, tax fraud, money laundering, and terrorist financing. The rule implements the **Corporate Transparency Act (CTA)**, which Congress passed three years ago but was *not* signed into law until early 2021 as part of that year's **National Defense Authorization Act**. The **rule will take effect 1/1/24** according to Treasury's **Financial Crimes Enforcement Network (FinCEN)**. The rule will establish a database of beneficial ownership information reported by a corporation or similar legal entity, including the full legal names, dates of birth, and addresses for all individuals who have "substantial control" over the business or who own at least 25% of it.

> **Comment:** This new requirement will affect over 25 million existing business entities and another 3 to 4 million new entities each year. Certain violations may result in the imposition of civil and criminal liability, including civil fines of $500/day, criminal fines of up to $250,000, and up to five (5) years in prison.

Reporting Entities: Any legal entity that is formed through a filing in a secretary of state's office is potentially a "reporting company." This includes but is *not* limited to corporations, LLCs, most partnerships, certain trusts, and other entities. Domestic and foreign entities can be "reporting companies." The CTA, however, provides twenty-three exemptions from the definition of a "reporting company," generally for larger entities or for entities that are already subject to "significant state or federal regulation."

Required Data on "Beneficial Owners" and "Applicants:" Legal names (including d/b/a names), business street address, the jurisdiction where they were formed or registered, and their tax ID number.

Who is a Beneficial Owner? Those who have "substantial control" over a reporting entity or who own or control at least 25% of it. Beneficial owners must provide their legal name, date of birth, residential street address, and the ID number from a state-issued ID, including a picture of the ID.

Potential Reporting Exception: Reporting companies, beneficial owners and applicants may apply to FinCEN for a "FinCEN Identifier," which they *may provide in lieu of their personal details*. But the requirements to obtain a FinCEN Identifier are proposed to be the same as would otherwise be required of beneficial owners.

Time Deadlines for FinCEN Reporting: Once the first wave of regulations takes effect, existing reporting companies will have one year to make their initial report to FinCEN. Entities formed on or after the regulation's effective date will have only 30 days to make their first reports (assuming FinCEN does *not* alter the timelines in its draft regulations). Any changed data will have to be reported within 30 days of the change. Errors in reported data must be corrected within 14 days of discovery.

Access to Reported Data: Federal law enforcement, intelligence agencies and regulators, *including the IRS*, will be able to access the data *without a court order*. State law enforcement will need a court order. **(Misc.; FinCEN)**

Comment: Exactly who may access the data, and how, will be defined in future regulations.

☞**IRS Issues Guidance on Form 1099-K for 2023 Tax Year** (**Tax Tip 2023-37**)

Comment: After receiving an IRS reprieve for the 2022 tax year, **Form 1099-K** will be back in full force for the current tax year. So, it makes sense to get the word out to our clients on how to deal with the reporting of such income. And, if the 1099-K has been issued erroneously, how to get that fixed.

Form 1099-K, Payment Card and Third-Party Network Transactions, is used to report certain payment transactions which the IRS is reminding taxpayers to include in their gross income when filing their 2023 **Form 1040**.
This could include payment for various business transactions, including income from:

- A business the taxpayer owns
- Self-employment
- Activities in the gig economy
- The sale of personal items and assets

Money received as a gift or for reimbursement, however, does *not* require a 1099-K. Taxpayers can minimize the chance of an error in such cases by informing friends or family members to correctly designate that type of payment as a "non-business-related transaction." The taxpayer should also make a note of what the payment was for and who sent it. If ever contested by the IRS, good recordkeeping will be key in resolving any audit issues. And if the information is incorrect on the **Form 1099-K**, taxpayers should contact the issuer immediately. The issuing organization's name will appear in the upper left corner on the form. In addition, taxpayers should keep a copy of all correspondence with the issuer for their records.

If a taxpayer receives a **Form 1099-K** in error and the taxpayer *cannot* obtain a corrected Form 1099-K, the taxpayers should follow the Service's updated guidance contained in their publication entitled **Understanding Your Form 1099-K**.

Comment: Also, it might be advisable to include **Form 8082, Notice of Inconsistent Treatment** when filing their return.

As far as the **Form 1099-K** reporting threshold for the 2023 tax year, the **American Rescue Plan of 2021** changed the reporting threshold requirement for payment apps, also known as "third-party settlement organizations." After a one-year delay, the new **Form 1099-K** reporting threshold will start in 2023. The *old* threshold was $20,000 and 200 transactions per year and this continues to apply to tax year 2022 and prior years. Now, the *new* threshold will apply at $600 or more (regardless of the number of transactions). **(Misc.; Form 1099-K)**

Comment: This dramatically lower threshold means that clients may receive a **Form 1099-K** who have *not*

received one in the past. Therefore, it makes a great deal of sense to get the word out now in the middle of the 2023 tax year and not wait until yearend or next busy season to confront the confusion this might generate during the height of next year's busy season.

Comment: The IRS has also updated its list of **FAQs** which provide additional tips and guidance on this third-party reporting requirement

☞**Using Tax Pro Account to Simplify Authorization Requests (Tax Tip 2023-24)**
Tax Pro Account lets tax professionals submit an authorization request to a taxpayer's **IRS Online Account**. This includes *both* power of attorney and tax information authorization requests. The taxpayers can then review, approve and sign the request *electronically*.

Tax Pro Account - Authorizations: To start an authorization in **Tax Pro Account**, tax professionals must enter their personal information and their clients' personal information exactly as it appears on IRS tax records.

- Taxpayers log into **IRS Online Account** and then simply check a box as their signature and submit the authorization request to the IRS.

- The signed authorization will go directly to the **IRS Centralized Authorization File** database and will *not* require manual processing.

- Most requests immediately appear on the list of approved authorizations in the taxpayer's **Online Account** and the tax professional's **Tax Pro Account**. But some authorizations may take up to 48 hours

Tax Pro Account - Key Points: Some other factors to keep in mind include:

- The digital authorization process is available only to *individual* taxpayers currently, *not* to businesses or other entities.

- Tax professionals must be in good standing with the IRS and already have a **Centralized Authorization File** number *before* making requests through **Tax Pro Account**. The **Centralized Authorization File** contains taxpayer and taxpayer representative records. This file lists the tax modules and the specific representative to whom the taxpayer has granted authority.

- Valid Power of Attorney Tax Information Authorization forms include **Forms 2848, 8821** and **706**.

- Later this year, IRS will add new features to **Tax Pro Account** "to make it even easier to use" for both tax professionals and their clients.

- Currently, the digital authorization process feature is available only to taxpayers with addresses in the United States. **(Misc.; Tax Pro Account)**

☞**Direct Deposit Option for Electronic Filing of Form 1040-X (IR-2023-22)**
This latest improvement for taxpayers will allow direct deposit for refund requests submitted on electronically filed **Form 1040-X, Amended U.S Individual Income Tax Return**. Previously, taxpayers who filed **Form 1040-X** had to wait for a *paper* check for any refund, a step that added time onto the amended return process.

Comment: Taxpayers file a total of approximately 3 million amended returns each year. The IRS began accepting the **Form 1040-X** electronically in 2020 but until now did *not* offer direct deposit as an option for a refund.

Comment: Taxpayers still have the option to submit a *paper* version of the **Form 1040-X** and receive a *paper* check (i.e., direct deposit would *not* be available in such instances).

Comment: Current processing time is *more than 20 weeks* for *both* paper and electronically filed amended

returns, as processing an amended return remains a manual process even if it is filed electronically. However, the IRS notes that filing electronically "cuts out the mail time, and including direct deposit information on an electronically submitted form provides a convenient and secure way to receive refunds faster." **(Misc.; Direct Deposit)**

☞**More Documents Can Now Be Uploaded to IRS Website** (**IR-2023-29**)

Taxpayers who receive certain notices requiring them to send information to the IRS now have the option of submitting their documentation online through **IRS.gov**. The Service stated that "this new secure step will allow taxpayers or their tax professional to electronically upload documents rather than mailing them in, helping reduce time and effort resolving tax issues."

Initially, the online correspondence feature will be available to taxpayers who receive one of nine IRS notices. For the most part, the IRS sends these notices to individual tax filers claiming various tax benefits, such as the **Earned Income Tax Credit** for low- and moderate-income workers, the **Child Tax Credit** for families with dependents, the **Premium Tax Credit** for those who obtain health coverage through the Health Insurance Marketplace and members of the military claiming **Combat Zone Tax Benefits**. **(Misc.; IRS Notices)**

> **Comment:** Taxpayers receiving these notices can respond securely to the IRS online, regardless of whether they have an IRS **Online Account**.

> **Comment:** Language on the notice informs the taxpayer to, "Send us your documents using the **Documentation Upload Tool** within 30 days from the date of this notice." The notices will also include the necessary link and a unique access code.

☞**Final Regs Issued on Mandatory E-filing of Business Returns** (**IR-2023-31**)

The Treasury has issued the final regulations (**T.D. 9972**) which amend the rules for filing returns and other documents electronically. These regulations will now require certain filers to e-file their returns beginning in 2024. The rules will affect filers of partnership returns, corporate income tax returns, unrelated business income tax returns, withholding tax returns, certain information returns, registration statements, disclosure statements, notifications, actuarial reports and certain excise tax returns.

> **Comment:** The final regs are intended to reflect changes made by the **Taxpayer First Act (TFA)** which are meant to increase e-filing "without undue hardship on taxpayers."

Specifically, the final regs:

- Reduce the 250-return threshold enacted in prior regulations to generally require electronic filing by filers of *10 or more* returns in a calendar year. The final regulations also create several new regulations to require e-filing of certain returns and other documents *not* previously required to be e-filed;

- Require filers to aggregate almost all information return types covered by the regulation to determine whether a filer meets the 10-return threshold and is required to e-file their information returns. Earlier regulations applied the 250-return threshold *separately* to each type of information return covered by the regulations;

- Eliminate the e-filing exception for income tax returns of corporations that report total assets under $10 million at the end of their taxable year, and

- Require partnerships with more than 100 partners to e-file information returns, as well as any partnerships required to file at least 10 returns of any type during the calendar year to e-file their partnership return.

> **Comment:** To help with this process, the IRS created a new, free online portal (**Information Returns Intake System (IRIS)**) in January to help businesses file **Form 1099** series information returns electronically.

In 2021, about 82% of all corporate income tax returns were e-filed, and almost 90% of partnership tax returns

were e-filed. The IRS receives nearly 4 billion information returns per year and expects to receive nearly 5 billion by 2028 (an increase caused partially by the lower threshold for **Form 1099-K**). In 2019, the IRS still received nearly 40 million paper information returns, even though approximately 99% of all information returns for that year were e-filed. **(Misc.; E-file Returns)**

> **Comment:** The final regulations generally provide "hardship waivers" for filers that would experience difficulty in complying with the e-filing requirements and "administrative exemptions" from the e-filing requirements to promote effective and efficient tax administration.

Code §162 - Business Expenses:

☞IRS Releases Standard Mileage Rates for 2023 (IR-2022-234)

The IRS has issued the 2023 optional standard mileage rates used to calculate the deductible costs of operating an automobile for business, charitable, medical or moving purposes. Beginning on Jan. 1, 2023, the standard mileage rates for the use of a car (also vans, pickups or panel trucks) will be:

- 65.5 cents per mile driven for business use, up 3 cents from the mid-year increase setting the rate for the second half of 2022 at 52.5 cents per mile

- 22 cents per mile driven for medical or moving purposes for qualified active-duty members of the Armed Forces, consistent with the increased midyear rate set for the second half of 2022

- 14 cents per mile driven in service of charitable organizations (the rate is set by statute and remains unchanged from 2022)

These rates apply to electric and hybrid-electric automobiles, as well as gasoline and diesel-powered vehicles. The standard mileage rate for business use is based on an annual study of the *fixed and variable costs* of operating an automobile. The rate for medical and moving purposes is based solely on the *variable* costs.

> **Comment:** Keep in mind that under the **Tax Cuts and Jobs Act**, taxpayers cannot claim a 2% miscellaneous itemized deduction for unreimbursed employee travel expenses (i.e., on **Form 2106**). Taxpayers also cannot claim a deduction for moving expenses (i.e., on **Form 3903**), unless they are members of the Armed Forces "on active duty moving under orders to a permanent change of station."

Taxpayers always have the option of calculating the *actual* costs of using their vehicle rather than using the standard mileage rates. Taxpayers can use the standard mileage rate but generally must opt to use it in the *first* year the car is available for business use. Then, in later years, taxpayers can choose *either* the standard mileage rate or actual expenses. Leased vehicles must use the standard mileage rate method for the *entire* lease period (including renewals) if the standard mileage rate is initially chosen. **(Code §162; Standard Mileage Rate)**

☞Clarity Needed on Travel Expenses for Remote Workers

The AICPA is asking both IRS and Treasury officials for updated guidance on remote working arrangements, especially with regard to travel reimbursements. Specifically, the issue of deductibility of travel expenses by employees often depends on whether they are "physically present in an employer-provided work space." For example, how should an employee be reimbursed for expenses incurred in traveling to an "employer-provided work location" when travel days are limited and the distance has increased over what would have been their normal commute. The AICPA maintains that its analysis of new scenarios involving various work arrangements (e.g., employer location-based, remote, and hybrid) had concluded that "current revenue rulings and interpretations of case law are outdated, do *not* reflect the current work environment, and are unclear in many instances." Furthermore, "The lack of updated guidance has left employers and employees in the untenable position of making decisions regarding employer workplace policies while the rules regarding amounts reported as payments, to or for the benefit of employees, remain uncertain." In many modern working arrangements, both the employer and the employee considered the latter's residence as the main site at which work is performed. As a result, "In many instances, existing tax guidance does *not* apply to today's work arrangements to determine when expenses are

deductible travel expenses and when such amounts are non-deductible commuting expenses."

A major recommendation is that the Treasury and the IRS revise **Rev. Rul. 99-7** to eliminate its reference to the "exclusive use" requirement under **Code §280A(c)** while also reflecting "modern work arrangements." In addition, the concept of "for the convenience of employer" should be updated. One alternative would be to establish a "safe harbor" to be used in determining a "principal place of business" with specific criteria that would no longer refer to the "exclusive use" requirement of **Code §280A(c)**.

Another issue is whether employers should be reassessing their fringe benefit programs in response to employees' questions about remote working arrangements. These include whether days spent in an employer-provided office are "travel days" on which remote workers could be reimbursed for their expenses. Because many employers have set policies and positions "based on reasonable interpretations of existing guidance," new guidance should be issued that takes into account any transition relief employers would need to facilitate compliance. **(Code §162; Remote Workers)**

Code §163(j) - Interest Expense Limitation:

☞FAQs on Sec. 163(j) Interest Expense Limitation

The IRS has issued **updated answers** to some basic questions about the limitation on the deduction for business interest expense, also known as the "Section 163(j) limitation." Prior to the **2017 Tax Cuts and Jobs Act (TCJA)**, **Code §163(j)** applied only to certain interest paid or accrued by corporations. However, the **TCJA** significantly changed the **Code §163(j)** limitation. On March 27, 2020, **Code §163(j)** was further amended by the **Coronavirus Aid, Relief, and Economic Security (CARES) Act**. These questions and answers address the **Code §163(j)** limitation after amendments by the **TCJA** and the **CARES Act**. **(Code §163(j); Interest Expense)**

> **Comment:** Keep in mind that the "price tag" for making this election is that "qualified improvement property" (QIP) is not eligible for bonus depreciation. Furthermore, such improvements must be depreciated using the "alternative depreciation system" (ADS) over a 20-year recovery period as opposed to the normal 15-year MACRS recovery period using the S/L method.

Code §168 - Depreciation - Partial Dispositions:

☞IRS Releases Revised Audit Technique Guide on Cost Segregation (IRS Pub. 5653)

Audit Technique Guides (ATGs) are intended to assist IRS examiners during audits "by providing insights into issues and accounting methods unique to specific industries." While ATGs are designed to provide guidance for IRS employees, they are also useful to small business owners and tax professionals who prepare returns. The IRS has recently released an updated comprehensive ATG to assist in evaluating cost segregation studies submitted by taxpayers in support of depreciation deductions when property is acquired or constructed. When only lump-sum costs are available, "cost estimating techniques" may be needed in order to segregate costs to individual components of property. **(Misc.; Cost Seg Studies)**

> **Comment:** The update was necessitated due to changes in the tax law which affected **Code §263A**, changes in accounting method, depreciation, bonus depreciation, Section 179 deduction, Section 179D deduction, and Qualified Improvement Property (QIP).

☞IRS "Process Unit" Examining Partial Dispositions of Buildings

The IRS has issued a **Process Unit** that provides guidance to its auditors for examining a taxpayer that elected to recognize a disposition as a "partial disposition" of a building under **Reg. §1.168(i)-8(b)(2)**.

Background: The **Modified Accelerated Cost Recovery System (MACRS)** is used to recover (i.e., depreciate) the basis of most business and investment property (i.e., depreciable assets) placed in service after 1986. (**IRS Pub. 946**, **"How to Depreciate Property"**) A "depreciable asset" is property owned by a taxpayer that has a determinable useful life of *more than one year* that is *used in the taxpayer's business or income-producing*

activity. In order to depreciate an asset, the taxpayer generally must have a "depreciable interest and basis in the asset." Usually a taxpayer has a "depreciable interest" in depreciable assets the taxpayer owns. However, leased property may be depreciated if the taxpayer "retains the incidents of ownership," such the risk of loss if the property is destroyed, in the property. Generally, a taxpayer's "unadjusted basis" in an asset is the asset's cost to the taxpayer. The taxpayer's adjusted basis is the asset's unadjusted basis adjusted for improvements and depreciation.

A building, including its structural components, used in a taxpayer's trade or business or in an income-producing activity, is a depreciable asset (**Reg. §1.168(i)-8(c)(4)(ii)(A)**), and each improvement or addition PIS *after* the original building is placed in service is a "separate depreciable asset." (**Reg. §1.168(i)-8(c)(4)(ii)(D)**) Generally, the "structural components" of a building are walls, partitions, floors, and ceilings, any permanent coverings such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. (**Reg. §48-1(e)(2)**)

A *portion* of a building is any part of the building that is less than the *entire* building. (**Reg. §1.168(i)-8(b)(4)**) **Reg. §1.168(i)-8(d)(2)** allows taxpayers to elect to recognize partial dispositions of MACRS property (i.e., "partial disposition election"), including the disposition of a portion of a building or one or more of its structural components. (**Reg. §1.168(i)-8(d)(2)**) The "partial disposition election" is an annual election and is made by reporting the gain or loss on a timely-filed original tax return, including extensions, for the tax year in which the taxpayer disposes of a portion of the building. (**Reg. §1.168(i)-8(d)(2)(ii)**)

> **Comment:** The "partial disposition election" came about as a result of the "repair regs" which were released in the fall of 2013. Nevertheless, it still seems to fly in the face of the repeal by Congress (as part of **ERTA '81**) of the "component depreciation" approach taken by taxpayers with regard to the depreciation of real estate assets. Furthermore, there has been no "sale or exchange" of the building itself. So, how is it possible to claim a Sec. 1231 ordinary loss without this prerequisite? Even the regs state that "Generally, a "disposition" occurs when ownership of an asset is transferred or when the asset is permanently withdrawn from use in the taxpayer's trade or business or income producing activity." (**Reg. §1.168(i)-8(b)(2)**)

IRS Examination Guidelines: The IRS has set out what auditors should look for when examining taxpayers who have made a "partial disposition election" with regard to a disposal of part of a building. According to the **Process Unit**, once an examiner has determined there is a risk that the taxpayer did *not* comply with the rule for reporting a partial disposition of a building (or, its structural components), the examiner will need to follow the "five steps" below to examine the compliance issue:

- First, the examiner should determine if the taxpayer partially disposed of a building or one of its structural components such as a sprinkler system. To do this, the examiner needs to review the taxpayer's records and confirm that the taxpayer has maintained records for its depreciable assets using the rules in **Reg. §1.167(a)-7(c)**. Also, the examiner should interview the taxpayer to evaluate how the taxpayer determined that a "partial disposition" occurred during the tax year. If the taxpayer cannot substantiate that a disposition occurred, the **Process Unit** recommends that the examiner disallow the partial disposition.

- Second, the examiner should identify exactly what portion of the building (or, structural components) the taxpayer disposed of. The examiner should review the taxpayer's books and records to determine whether they provide enough information to substantiate the identity of the portion of the building (or, structural component(s)) the taxpayer disposed of. The examiner should also verify that the taxpayer has a depreciable interest in that property.

- Third, the examiner should identify the building that was partially disposed of and its placed in service date. Again, the examiner will need to review the taxpayer's books and records. According to the **Process Unit**, a taxpayer should use the "specific identification method" of accounting when the taxpayer disposes of an entire

building (or, a portion of a building). (**Reg. §1.168(i)-7(b); Reg. §1.167(i)-8(h)(3)(i)**) The "specific identification method" requires the taxpayer to put the building, or portion of the building being disposed of, in a "single asset account," (i.e., an account that holds only one asset). When it is impracticable to identify the partially disposed of building using the taxpayer's books and records because the taxpayer did *not* use the specific identification method, the taxpayer may use one of the "simplified identification methods" (such as First-In-First-Out (FIFO or modified FIFO) provided in the disposition regs to identify the portions of a building disposed of. (**Reg. §1.168(i)-8(g)(2) and Reg. §1.168(i)-8(g)(3)**)

- Fourth, the examiner should determine the adjusted basis of the disposed of portion of the building in order to verify that the taxpayer properly calculated gain or loss on the disposition of that portion. According to the **Process Unit**, the examiner's starting point for determining the adjusted basis of the disposed of portion of a building is the "unadjusted basis" of the *entire* building. Once the unadjusted basis of the entire building is determined, then the adjusted basis of the disposed of portion can be computed. The examiner should remember to account for any additional first-year depreciation that is attributable to the disposed portion of the building.

- Fifth, the examiner needs to verify that the taxpayer reduced the adjusted basis of the remaining portion of the building to account for the partial disposition. The examiner should check that the remaining asset reflects only its remaining adjusted basis. **(Code §168; Partial Dispositions)**

☞**Pro-taxpayer "Change-in-use" Regs**

What if the taxpayer changes the use to which the property is put sometime during its recovery period (i.e., before all of its basis has been depreciated)? To answer this question, the IRS has issued **regs** which dictate that the **recovery period would actually have to be switched at this point in time and the asset's remaining basis be recovered over this new time frame**. However, it is key to understand that the taxpayer is **permitted to elect out of these regs** and therefore **continue to write off** the asset's cost **over its original recovery period**.

> **Example: "Like-kind Exchange of Commercial Real Estate for Residential Real Estate"**
> A taxpayer owned a MACRS 39-year commercial building which was placed in service four years ago and for which there was still an adjusted basis of $500,000 remaining. He then exchanged it for an apartment building in a like-kind exchange where there was no boot (i.e., there was no realized or recognized gain in this "deferred ***Starker*** exchange). As a result, he would use the carryover basis of $500,000 for the initial basis of the apartment building.
>
> Under these proposed regs, since there was a "change in use" (i.e., going from a commercial to residential property), the rule would be that the apartment building would have to be depreciated now over a new "fresh start" period of 27.5 years using the mid-month convention as of the time that the new building was placed in service (i.e., which can be up to 180 days from when the LKE was originally done).
>
> **Comment:** In this example, it is to the taxpayer's advantage to have the "change-in-use" regs apply as opposed to electing out and having to continue depreciating the $500,000 carryover basis over the remaining 35 years that had existed for the former commercial building that the taxpayer owned.
>
> **Example: "Like-kind Exchange of Residential Real Estate for Commercial Real Estate"**
> A taxpayer owned a MACRS 27.5 residential apartment building which was placed into service 7.5 years ago and for which there was still an adjusted basis of $500,000 remaining. He then exchanged it for a commercial building in a like-kind exchange where there was no boot (i.e., there was no realized or recognized gain in this "deferred ***Starker*** exchange). As a result, he would use the carryover basis of $500,000 for the initial basis of the commercial building.
>
> Under these proposed regs, the taxpayer could opt to *not* have the normal "change-in-use" regs apply. As a result, "shoes depreciation" would apply and the carryover basis of $500,000 of the new commercial building could be written off over the 20 years that had remained on the residential building which he had previously owned. **(Code §168; Change-in-use Regs)**

☞**Properly Depreciating "Mixed-use Property"**

It is not unusual to have a retail establishment on the ground floor (i.e., street level) with the upper floors

consisting of dwelling units such as apartments. Nevertheless, the property cannot be split for classification purposes (i.e., part of it being in the MACRS 39-year commercial real estate recovery class, with the remainder being 27.5-year residential property). Instead, an "80%/20% test" is employed **as of the date that the property is first placed into service**.

Comment: This "80%/20% test" can best be explained by stating that if > 20% of the gross rents in a "mixed-use building" are derived from the commercial space, then it would be classified as MACRS 39-year commercial real estate. This is in spite of the fact that most of the actual square footage might be allocable to the residential space in the building. In other words, it would be the gross rents and *not* the square footage which would control for MACRS classification purposes.

This can result in a building that has vacant retail (i.e., commercial) space when first purchased (i.e., and which is refurbished over the next few months) being grouped together with the residential units resulting in an overall MACRS 27.5-year life for the *entire* structure. Even when the retail space is eventually placed into service, the property's recovery period is still *not* split into residential v. commercial at that point in time. Nor, does it appear that the original 27.5-year recovery period has to now be reclassified into 39-year commercial property for the remainder of its life for depreciation purposes (i.e., **even if more than 20% of the gross rents were now being derived from the commercial space**), given that an election out of the "change-in-use" regs is properly made. **(Code §168; Mixed-use Real Estate)**

Code §179 - Immediate Expensing Election:

☞**Sec. 179 Immediate Expensing Increasing to $1,160,000 (Notice 2022-55)**

The annual cap on Sec. 179 immediate expensing is going up to $1,160,000 from $1,080,000 in 2022. Meanwhile, the phaseout limit commences at $2,890,000 (up from $2,700,000 in 2022). Bonus depreciation, however, is slated to go down from 100% to just 80% in 2023 unless Congress acts in the interim to extend the 100% allowance. For "heavy vehicles" such as SUVs, the Sec. 179 cap will be set at $28,900 for 2023 (although bonus depreciation could be used instead to circumvent this cap). Bonus depreciation can also be used to increase the first-year "luxury car cap" by $8,000.

Some key items to keep in mind on these two deductions:

- A number of states only allow Sec. 179 and not bonus depreciation (and, even a limited $25,000 cap on Sec. 179 in selected states). So, Sec. 179 immediate expensing should be consider in these selective states instead of solely claiming bonus depreciation on the federal tax return.

- Sec. 179 must be elected on **Form 4562** whereas bonus depreciation continues to be automatic unless an "election out" by MACRS class is included in the tax return (and, normally, an amended return cannot be used to make this "election out" of bonus depreciation).

- Sec. 179 can be elected (or, revoked) on an amended return (assuming that the tax year is still open). On the other hand, assuming that an "election out" of bonus depreciation was *not* in effect for the year that otherwise qualifying property was first placed in service, this deduction can only be "caught up" by filing a **Form 3115** for a "change in the method of accounting" for the taxpayer.

Comment: This "catching up" on missed depreciation is an "automatic consent" situation and therefore no user fee need to be paid when filing **Form 3115**. And, the "DCN Code #7" which indicates that the taxpayer is changing from an "erroneous method of accounting to a correct one" should be listed on page one of the form.

- Both write-offs can be used on either new or used property (due to the change made by the **TCJA**)

- There is no cap on the bonus depreciation amount, nor can it be "phased out." Furthermore, bonus depreciation can create (or, increase) an NOL (although it might be subject to the new **Code §461(l)** "excess business loss" limitation). Conversely, the Sec. 179 immediate expensing amount must be "covered" with sufficient "trade or

business taxable income." Other limitations such as insufficient at-risk basis (for a flowthrough entity owner) or the passive loss rules might come into play to prevent these write-offs (nevertheless the basis of the asset(s) involved is fully reduced in the interim).

- Sec. 179 and bonus (and regular) depreciation are only available for business property that you "placed in service" during the tax year. Property is "placed in service" when it is ready and available for its assigned function in your business. As long as it is available for such use, you do *not* have to actually use the property for business during the year to take depreciation.

☞**Interaction of Sec. 179 and Bonus Depreciation on Luxury Car Caps**
Rev. Proc. 2019-13 provides a "safe harbor method" of accounting for determining depreciation deductions for passenger automobiles that qualify for bonus depreciation and that are also subject to the "luxury car caps" found in **Code §280F(a)**.

Comment: This discussion also covers the impact on the calculation of each year's depreciation deduction where Sec. 179 immediate expensing is elected in the *same* (i.e., first) year that bonus depreciation applies (i.e., an "election out" of bonus is *not* being made for the 5-year MACRS class for the year that the vehicle is placed into service).

Comment: This revenue procedure applies to any passenger vehicle that has a cost (i.e., unadjusted basis) which exceeds the current first-year luxury car cap (i.e., $20,200 for 2023) and for which Sec. 179 was *not* elected, but bonus depreciation otherwise applied (i.e., there was no "election out" of bonus depreciation for the tax year that the vehicle was placed in service).

For a passenger automobile that is qualified property under **Code §168(k)** and for which the 100-percent additional first year depreciation deduction is otherwise allowable, **Code §168(k)(2)(F)(I)** increases the first year luxury car cap under **Code §280F(a)(1)(A)(i)** by $8,000.

Code §280F(d)(1) provides that any deduction allowable under **Code §179** for a passenger automobile is subject to the limitations of **Code §280F(a)** in the *same* manner as if it were a depreciation deduction allowable under **Code §168**.

Potential Issue with Bonus Depreciation: If the original basis of the vehicle was greater than the applicable luxury car cap for the year placed in service (i.e., $20,200 for 2023), and 100% bonus depreciation was claimed, the excess could *not* be deducted until the 5-year MACRS recovery period had ended while also being subject to the cap which otherwise applied for the 4th year and later (i.e., $6,960 for vehicles placed in service in 2023). As a result, for a vehicle costing more than $20,200 in 2023, you would get no depreciation deduction for years 2024 through 2028 with this excess being claimed starting in 2029, subject to the $6,960 cap.

Comment: The 5-year MACRS recovery period with the half-year convention would run from the middle of the first year until the middle of the sixth year. So, if the rule outlined above applied, depreciation of any excess basis would *not* recommence until the seventh year.

Example: "Depreciating Luxury Vehicle w/o Safe Harbor"
A taxpayer purchases a vehicle in 2023 costing $60,200 for which 100% bonus depreciation applies, but for which no Sec. 179 immediate expensing amount is elected. Without the "safe harbor" discussed below, they would deduct $20,200 for the year placed in service (i.e., 2023), but nothing for years 2024 through 2028. Then, starting in 2029, $6,960 could be claimed for the remaining $40,000 of undepreciated basis remaining until the entire cost of the vehicle had been deducted (i.e., $40,000 divided by $6,960/year would mean that the car would *not* be fully depreciated until 5.75 years later, or 2034 for a vehicle first placed in service in 2023). In other words, it would take 12 tax years (i.e., 2023 to 2034) to fully depreciate this "luxury vehicle."

Safe Harbor Addresses Issue: To mitigate the anomalous result that occurs in the taxable years subsequent to the placed-in-service year and before the first taxable year succeeding the end of the recovery period for a passenger automobile, the IRS has offered a "safe harbor alternative." This safe harbor method of

accounting is elected by simply applying it to deduct depreciation of its passenger automobile for the first taxable year *succeeding* the placed-in-service year of the passenger automobile as follows:

1. The 200% DB MACRS depreciation schedule for 5-year property (i.e., as listed in **Rev. Proc. 87-56**) must be used;

2. For the placed-in-service year of the passenger automobile, the taxpayer deducts the *first* year limitation amount under **Code §280F(a)(1)(A)(i)** (i.e., $20,200 for 2023); and

3. For the taxable year subsequent to the placed-in-service year and for each succeeding taxable year in the recovery period, the taxpayer determines the depreciation deduction for the passenger automobile by multiplying the remaining adjusted depreciable basis of the passenger automobile by the annual depreciation rate for each taxable year subsequent to the placed-in-service year (i.e., again, using the 200% DB MACRS depreciation schedule for 5-year property), subject to the annual **Code §280F** luxury car cap amounts.

> **Comment:** As discussed in **Rev. Proc. 2023-14**, for vehicles placed in service in 2023, $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year.

4. Any excess still remaining after the end of the sixth year (i.e., again, with the half-year convention, the 5-year MACRS recovery period runs from the middle of the first year until the middle of the sixth year) is treated as a deductible depreciation expense for the succeeding taxable years, subject to the limitation under **Code §280F(a)(1)(B)(ii)** (i.e., $6,960 for each succeeding tax year for vehicles placed in service in 2023) until the total remaining cost of the vehicle if fully depreciated.

Example: "Depreciating Luxury Vehicle w/ Safe Harbor"
A taxpayer purchases a vehicle in 2023 costing $60,200 for which 100% bonus depreciation applies, but for which no Sec. 179 immediate expensing amount is elected. With the "safe harbor," they would claim bonus depreciation equal to $20,200 (i.e., first year luxury car cap) for 2023. Then, the remaining basis of $40,000 would be claimed in the ensuing years (i.e., using the 200% DB MACRS depreciation table for 5-year property) limited to the car caps listed above (i.e., $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year). As a result, 32% x $40,000 = $12,800 for 2024; 19.2% x $27,200 = $5,222 for 2025; 11.52% x $21,978 = $2,532 for 2026; 11.52% x $19,446 = $2,240 for 2027; 5.76% x $17,206 = $991 for 2028. The total depreciation claimed for tax years 2023 through 2028 equals $20,200 + $23,785 = $43,985. Therefore, heading into the 2029 tax year, there is still $60,200 - $43,985 = $16,215 of basis remaining to be depreciated. Using the $6,960 car cap for the fourth and succeeding tax years, you would take $6,960 for 2029; $6,960 for 2030; and the final $2,295 for 2031.

Example: "Depreciating Luxury Vehicle w/ Sec. 179 Immediate Expensing, But Electing Out of Bonus Depreciation"
A taxpayer purchases a vehicle in 2023 costing $60,200 for which a Sec. 179 immediate expensing election is made on **Form 4562** for $12,200. He made this decision since his business is located in a state that allows Sec. 179 immediate expensing, but nothing for bonus depreciation. Also, note that the luxury car cap for the first year is only $12,200 (v. $20,200) since an election out of bonus depreciation has been made for all MACRS 5-year property for 2023 (i.e., the year that the vehicle was placed in service).

For the remainder of the 5-year MACRS recovery period (i.e., 2024 to 2028), he would use the 200% DB table in **Rev. Proc. 87-56**. As a result, he would get $12,200 for the year that the vehicle was placed in service which would leave $50,000 to be depreciated going forward as follows: 32% x $50,000 = $16,000 for 2024; 19.2% x $34,000 = $6,528 for 2025; 11.52% x $27,472 = $3,165 for 2026; 11.52% x $24,307 = $2,800 for 2027; 5.76% x $21,507 = $1,239 for 2028. The total depreciation claimed for tax years 2023 through 2028 equals $12,200 + $30,468 = $42,668. Therefore, heading into the 2029 tax year, there is still $60,200 - $41,932 = $18,268 of basis remaining to be depreciated. Using the $6,960 car cap for the fourth and succeeding tax years, you would take $6,960 for 2029; $6,960 for 2030; and the final $4,348 for 2031.

Example: "Depreciating Luxury Vehicle w/ Sec. 179 Immediate Expensing, But Failing to Elect Out of Bonus Depreciation"

A taxpayer purchases a vehicle in 2023 costing $60,200 for which a Sec. 179 immediate expensing election is made on **Form 4562** for $20,200. He made this decision since his business is located in a state that allows Sec. 179 immediate expensing, but nothing for bonus depreciation. Since *both* Sec. 179 and bonus depreciation apply for 2023, the luxury car cap would still limit the overall depreciation deduction to just $20,200. But given that an election out of bonus depreciation was *not* made in 2023 for MACRS 5-year property, **no depreciation can be claimed for tax years 2024 through 2028.** Then, starting in 2029, subject to the $6,960 luxury car cap that applies for the fourth and succeeding tax years, the remaining $40,000 would be would be recovered over the next 5.75 years (i.e., 2029 through 2034).

Comment: The obvious alternative is to lease a "luxury car" and therefore be able to simply deduct the annual lease payments, less the rather minor "annual income inclusion amount," for each tax year (i.e., given that the FMV for the vehicle was $60,000 or more when first placed in service). Another option would be to purchase a "heavy SUV" which would have a Sec. 179 cap of $28,900 for 2023, but no cap if bonus depreciation would instead claimed. **(Code §280F; Luxury Car Caps)**

Comment: Unless Congress acts, bonus depreciation would begin to phase out at a rate of 20% per year starting in 2023. So, in the examples above, unless a "tax extenders" bill was passed, bonus depreciation would only be 80%.

Code §274 - Meals & Entertainment Expenses:

☞Clarification on 50% Business Meal Deduction for 2023 Onward (Tax Tip 2022-91)

The IRS encourages businesses to begin planning now to take advantage of tax benefits available to them when they file their 2022 federal income tax return. This includes the "enhanced business meal deduction." For 2021 and 2022 only, businesses can generally deduct the *entire* cost of business-related food and beverages "purchased from a restaurant." Otherwise, the limit is usually 50% of the cost of the meal.

To qualify for the "enhanced deduction," the IRS is advising business taxpayers to take the following steps:

Comment: With the deduction for business meals going down to only 50%, the following requirements nevertheless remain in place.

- The business owner or an employee of the business must be present when food or beverages are provided;

- Meals must be from restaurants, which includes businesses that prepare and sell food or beverages to retail customers for immediate on-premises or off-premises consumption;

- Payment or billing for the food and beverages occurs *after* December 31, 2020, and *before* January 1, 2023; and

- The expense cannot be lavish or extravagant

Comment: It is important to keep in mind that grocery stores, convenience stores and other businesses that mostly sell pre-packaged goods *not* for immediate consumption, do *not* qualify as "restaurants" for purposes of the 100% deduction for business meals. In addition, employers may *not* treat certain employer-operated eating facilities (e.g., on-site cafeterias) as "restaurants," even if they operate under contract by a third party. This is also true of the "kitchenette" that a firm might have in its office space where snacks and drinks are provided at no cost for the convenience of their employees (although many employers would argue that this is a "de minimis" fringe benefit).

The Service has also offered some guidance regarding what business owners need to know about certain costs:

- The cost of the meal can include taxes and tips; and

- The cost of transportation to and from the meal is *not* part of the cost of a business meal;

With regard to venues also providing entertainment along with food and beverage, business owners may be able to deduct the costs of meals and beverages provided during an entertainment event if *either* of these apply:

- The purchase of the food and beverages occurs *separately* from the entertainment, or

- The cost of the food and beverages is *separate* from the cost of the entertainment on one or more bills, invoices, or receipts. **(Code §274; Business Meals)**

Code §280F - Luxury Car Caps:

☞**2023 Luxury Car Caps & Annual Income Inclusion Amounts (Rev. Proc. 2023-14)**
Rev. Proc. 2023-14 provides: (1) two tables of limitations on depreciation deductions for owners of passenger automobiles placed in service by the taxpayer during calendar year 2023; and (2) a table of dollar amounts that must be used to determine income inclusions by lessees of passenger automobiles with a lease term beginning in calendar year 2023 where the FMV of the leased vehicle is $60,000 or more. The tables detailing these depreciation limitations and amounts used to determine lessee income inclusions reflect the automobile price inflation adjustments required by **Code §280F(d)(7)**.

Luxury Car Caps: The **Code §280F** depreciation deduction limits for passenger autos (including trucks and vans) first placed in service during 2023 are listed in these tables. For passenger autos acquired after 9/27/17, placed in service during 2023, and subject to bonus depreciation under **Code §168(k)**, the depreciation limits are $20,200 for the first year, $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year (i.e., $58,360 for the first four years). For passenger autos placed in service during 2023 that are *not* subject to **Code §168(k)** bonus depreciation (i.e., an "election out" of bonus depreciation was made for MACRS 5-year property), the depreciation limits are $12,200 for the first year (i.e., the extra $8,000 for bonus depreciation is eliminated), $19,500 for the second year, $11,700 for the third year, and $6,960 for each succeeding year (i.e., $50,360 for the first four years). **(Code §280F; Luxury Car Caps)**

Code §446 - General Rules for Method of Accounting:

☞**Revised Form 3115 Change in Accounting Method Released (Ann. 2023-12)**
The IRS has revised **Form 3115, Application for Change in Accounting Method**, and its **Instructions**. The **Form 3115 (Rev. December 2022)** is the current form and it replaces the December 2018 version of the **Form 3115**. **Ann. 2023-12** also provides guidance to allow for a "reasonable period" for taxpayers to transition to the December 2022 **Form 3115**. **(Code §446; Form 3115)**

Comment: In the **Kiplinger Tax Letter (4-13-23)** it clarified that for returns filed before April 18, 2023, *either* 2018 or the 2022 version could be used. However, going forward, it stated that the revised 2022 version must be used for all **Form 3115** requests.

Comment: Even though it is an "automatic consent" change in accounting method to "catch up" on any missed depreciation or amortization, **Form 3115** must still be filed with the IRS. In a recent case, a company that owns and leases farmland, including "base acres" (which are essentially a contractual right to receive federal farm subsidies for producing certain commodities) failed to amortize these rights. Instead of filing **Form 3115** to catch up on this missed amortization, the company simply started to take the write-off on a prospective basis. The Tax Court upheld the Service's determination that the deduction should be disallowed. (Cf. ***Conmac Investments*, TC Memo. 2023-40 (3/27/2023)**)

Code §461 - General Rules for Taxable Year of Deduction:

☞**New Safe Harbor for Common Improvements for Real Estate Developers (Rev. Proc. 2023-09)**
Rev. Proc. 2023-09 *obsoletes* **Rev. Proc. 92-29** and provides new rules and conditions for implementing the

optional safe harbor method of accounting for real estate developers to determine when "common improvement costs" may be included in the basis of individual units of real property in a real estate development project to determine the gain or loss from the sale of those units. Under the **Alternative Cost Method**, a developer includes the share of the estimated cost of common improvements allocable to the units sold in the basis of such units regardless of whether the costs have been incurred under **Code §461(h)** (i.e., "all-events test"), subject to certain limitations. This revenue procedure also provides guidance on the application of the **Alternative Cost Method** to long-term contracts accounted for under **Code §460** and the regulations thereunder.

Developers that want to use the **Alternative Cost Method** generally will be required to apply the method to *all* qualifying projects in a trade or business instead of on a "per-project basis" as was required under **Rev. Proc. 92-29**. Developers will also be permitted to use a "short" **Form 3115, Application for Change in Accounting Method**, to make method changes to apply the **Alternative Cost Method** if: (1) each change results in a **Code §481(a)** adjustment of zero, and (2) waives the eligibility rule in **section 5.01(1)(f)** of **Rev. Proc. 2015-13** which prohibits taxpayers from filing an "automatic method change" if the taxpayer has made or requested a change for the *same* item during the 5 taxable years ending with the year of change **(Code §461; Common Improvements)**

> **Comment:** The term "common improvement" means any real property or improvements to real property that benefit two or more units that are separately held for sale that the developer reasonably anticipates it will incur under **Code §461(h)** during the ten succeeding taxable years (i.e., a "super accrual" ten-taxable year horizon). The developer must be contractually obligated or required by law to provide the common improvement and must *not* be able to recover the cost of the common improvement through depreciation (i.e., since these improvements become part of the basis of the "inventory lots" being sold). Examples of common improvements include streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools.

> **Comment:** A key requirement is that this "safe harbor" for common improvements anticipated to be made by the real estate developer must be done by the due date (including extensions) for the first tax year in which these "inventory units" will be sold.

Code §6038D - Foreign Asset Reporting:

☞**Supreme Court Holds FBAR Penalties Apply on "Per Report Basis" (*Bittner v. U.S.*, No. 21-1195 (S. Ct., 2/28/2023))**

The U.S. Supreme Court held that the penalty for violating the **Report of Foreign Bank and Financial Accounts (FBAR)** rules to report a qualifying account applies "on a per-report basis," and *not* "on a per-account basis." In ***Bittner***, the U.S. taxpayer failed to file FBARs while living in Romania. Upon learning of his reporting obligations, he filed FBARs that incorrectly stated his interest in 25 or more qualifying accounts (i.e., taxpayer actually had 272 foreign accounts). The U.S. government assessed $2.72 million in civil penalties for "non-willful violations" for *each* unreported account, the $10,000 maximum penalty for his 272 unreported accounts. A district court reduced the assessment to $50,000 for failure to file five annual FBARs. The court's decision resolved a split between the 5th Circuit, which held the penalty applied on a "per-account basis," and the 9th Circuit, which held the penalty applied on a "per-report basis." **(Code §8938; FBAR)**

> **Comment:** Taxpayers who have a financial interest in (or, signature authority over as indicated in the question on **Schedule B**) foreign financial accounts must file a **Report of Foreign Bank and Financial Accounts (FBAR)** on **Financial Crimes Enforcement Network (FinCEN) Form 114** if the aggregate value of the foreign financial accounts exceeds $10,000 at *any* time during the calendar year. In a recent case, a federal district court entered a $3.1 million consent judgment for "willful FBAR penalties" owed by a taxpayer. Not only does **Form 114** need to be filed with the FinCEN, **Form 8938 (Statement of Specified Foreign Financial Accounts)** also needs to be *separately* filed with the IRS when individual clients, estates, and trusts have foreign bank accounts and foreign financial accounts. (***U.S. v. Manafort, Jr.*, 131 AFTR 2d 2023-XXXX (DC FL, 2/22/2023)**).

> **Comment:** It should be noted that this was a very divided 5-to-4 opinion by the Supreme Court.

Code §6511 - Limitations on Credit or Refund:

☞**IRS Increases SOL Period for Certain Refund Claims (Notice 2023-21)**
In response to COVID-19, the Service, pursuant to **Code §7508A**, issued **Notice 2020-23** and **Notice 2021-21** to postpone certain return filing due dates. However, these Notices did *not* serve to increase the lookback (i.e., statute of limitations) period for refund claims for such returns under **Code §6511(b)(2)(A)**. As a result, some payments that taxpayers made, including estimated and withheld income taxes deemed paid on April 15th of each year for calendar-year taxpayers, will fall outside of the lookback period if taxpayers filed their returns *after* the normal April 15th deadline. If the payments fall outside of the lookback period, then, despite filing a timely refund claim, a taxpayer cannot be refunded those payments. Using the Secretary's "disaster relief authority" under **Code §7508A(a)**, this notice disregards the periods from April 15, 2020 to July 15, 2020, and from April 15, 2021 to May 17, 2021, in determining the beginning of the lookback period to align the lookback periods with the postponed return filing due dates. **(Code §6511; Tax Refunds)**

☞**Financial Disability When Filing Late Tax Refund Claims**
Financial disability can serve as a legitimate reason for allowing a late-filed refund claim. The normal three-year statute-of-limitations period for seeking a tax refund is extended in cases in which taxpayers are found to have been unable to manage their financial affairs because of medically diagnosed, serious long-term physical or mental impairments. Nevertheless, proving eligibility for this late filing relief can be difficult as demonstrated in the following cases.

First of all, this relief applies only to individuals and *not* to refund claims of estates. For example, a woman who was appointed as executrix of her aunt's estate timely filed an estate tax return and paid the tax. Five years later, she then filed an amended Form 706, seeking a refund stating that it was late of her mental ailments. Although the court was sympathetic, it refused to extend financial disability to estate tax returns (***Carter*, D.C., Ala.**).

In addition, this relief will also not apply if someone else is authorized to act for the taxpayer with regard to their financial matters. For instance, an elderly man gave his son a written power of attorney over his affairs, allowing the son to act on his dad's behalf in financial transactions. But, again, this precluded the tolling of the normal three-year refund claim period (***Stauffer*, 1st Cir.**). **(Code §6511; Tax Refunds)**

Code §6651 - Penalty for Failure to File or Pay Tax:

Code §6662 - Accuracy Related Penalty:

☞**Disallowed Charitable Contribution Valued at Zero for Accuracy-related Penalty Purposes (*Fakiris*, TC Memo 2020-157 (11/19/2020))**
The Tax Court has found that a disallowed charitable donation should be valued at "zero" for purposes of determining the amount of the accuracy-related penalty. As a result, the taxpayer in this instance was subject to the 40% penalty for a "gross valuation misstatement."

Background: Code §6662(a) and **Code §6662(b)(3)** imposes an accuracy-related penalty equal to 20% of the portion of an underpayment of tax "attributable to * * * [a]ny substantial valuation misstatement." For purposes of **Code §6662**, "a substantial valuation misstatement" exists if "the value of any property (or, the adjusted basis of any property) claimed on any return of tax... is *150% or more* of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)". (**Code §6662(e)(1)(A)**) However, if the value or adjusted basis of the property claimed on the return is *200% or more* of the amount determined to be the correct amount of such value or adjusted basis, a "gross valuation misstatement" exists, and the penalty imposed increases to 40%. (**Code §6662(h)**)

A "gross valuation misstatement" is considered to exist when the correct value or adjusted basis of property is zero and the value or adjusted basis claimed on the return for such property is greater than zero. (**Reg. §1.6662-5(g)**) In ***Blau*, 23 AFTR 2d 2019-1960 (CA Dist Col, 5/24/2019)**, the district court completely disallowed

a charitable contribution deduction for donations of a remainder interest, for failure to satisfy statutory substantiation requirements (i.e., the donor failed to file completed appraisal summaries). The court, nevertheless, found it necessary to ascertain the fair market value of the remainder interest in order to decide whether the value claimed on the return resulted in "gross" or "substantial" valuation misstatements for purposes of **Code §6662(h)**.

In another case, the transaction at issue concerned a taxpayer who contributed offsetting currency options to a partnership to create an artificially inflated basis in his partnership interest, which, following the subsequent liquidation of his partnership, ultimately resulted in his claiming significant non-economic tax losses. The Supreme Court found that the contribution of the currency options lacked economic substance and, therefore, the basis of the property contributed to the partnership was zero for purposes of determining whether there was a "gross" or "substantial" valuation misstatement. (***Woods*, 112 AFTR 2d 2013-6974 (S Ct, 10/9/2013)**) **(Code §6662; Tax Penalties)**

☞**Tax Attorney Still Liable for Substantial Underpayment Penalty Despite Relying on Tax Expert (*Babu*, TC Memo. 2020-121 (8/17/2020))**

A tax attorney's maintained that he should *not* be subject to a substantial underpayment penalty of almost $1.5 million, claiming the penalty "was erroneous because he relied in good faith on the advice of a qualified tax professional." But, the Tax Court rejected his pleas for a number of reasons, one of them being "the lawyer's ample tax experience." **(Code §6662; IRS Penalties)**

Code §6672 - Trust Fund Penalty:

☞**Nursing Home Officer's Nonpayment of Withholding Taxes Not Willful - Trust Fund Penalty Not Applied (*Preimesberger*, 126 AFTR 2d 2020-5143 (DC CA, 08/05/2020))**

A district court has concluded that a nursing home officer's failure to pay withholding taxes was *not* "willful" as a matter of law. The officer paid other creditors before the IRS while trying to comply with mandatory federal and state regulations that required him, despite a severe cashflow problem, to keep the nursing homes operating at the existing standard of care.

Facts: The taxpayer was employed by Meridian Health Services Holdings, Inc. ("Meridian") to operate five skilled nursing home facilities in California. From 2010 through 2015, "the facilities accrued substantial Medicare and Medi-Cal receivables due from the United States." But eventually the cashflow problem became so acute that the facilities could *not* meet all their operational expenses. As a result, the taxpayer arranged for Meridian to bridge the cashflow situation by drawing on a line of credit from a bank. However, the bank would only authorize and provide funds "for the payment of net wages and other expenses necessary to maintain the facilities' standard of care." As a result, the facilities was *not* permitted to use the funds to pay their withholding tax obligations. And, the taxpayer insisted that the facilities "could *not* simply cease operations to resolve its cashflow problems." As mentioned above, under various federal and state regulations, the facilities "had to remain open and maintain the existing standard of care for all residents, despite its cashflow problems, until it complied with regulatory closing procedures and could officially close." Furthermore, violations of these regulations carried civil and criminal penalties. Nevertheless, in 2019, the IRS assessed "trust fund recovery penalties" against the taxpayer for the second, third and fourth quarters of 2014 and the first and second quarters of 2015.

District Court Decision: The Court found that failure to pay withholding taxes *not* "willful" as a matter of law. The available evidence confirmed that the facilities could *not* just cease operations because federal and state regulations (i.e., "nursing home regulations") prevented nursing homes and skilled nursing facilities from simply closing their doors. Instead, the nursing home regulations required such facilities:

1. To follow a specific closing process; and

2. To maintain the existing standard of care until closure.

Based on this evidence, the court determined that the taxpayer "had to keep the facilities open and maintain the standard of care until he could comply with the regulatory process for closing them." And, since there was no evidence that the taxpayer had any funding options other than the bank's line of credit, the court agreed that the

only way that he could meet his obligations under the nursing home regulations was to comply with the restrictions that the bank placed on the funds he borrowed. **(Code §6672; Trust Fund Penalty)**

> **Comment:** It was a shame that the taxpayer could not have settled this issue at the IRS audit or appeals level, but instead had to go through the expense and time involved by taking this matter to court. The IRS never alleged that the taxpayer had access to any funds, other than the bank loan, that he could use to pay the withholding taxes.

Notes:

FROM CONSULTING CALLS:

Miscellaneous:

☞**IRS Guidelines for Business Terminations (Tax Tip 2022-122)**

The Service has come out with a useful "Tax Tip" for those business clients who have decided to close their doors and file that final tax return. However, there are a few things business owners need to do before they close down their business. Obviously, they need to fulfill their federal tax responsibilities. It is also important to notify the IRS of their plans.

The IRS has stated that business owners take these steps when closing a business:

- **File a final tax return and related forms:** The type of return to file and related forms depends on the type of business.

- **Take care of employees:** Business owners with one or more employees must pay any final wages or compensation, make final federal tax deposits and report employment taxes.

- **Pay any taxes owed:** Even if the business closes now, tax payments may be due next filing season.

- **Report payments to contract workers:** Businesses that pay contractors at least $600 for services including parts and materials during the calendar year in which they go out of business, must report those payments (i.e., on **Form 1099 - MISC**).

- **Cancel EIN and close IRS business account:** Business owners should notify the IRS so they can close the IRS business account.

- **Keep business records:** How long a business needs to keep records depends on what is recorded in each document.

The IRS **website** has information to help guide business owners through the process of shutting down. Small businesses and self-employed taxpayers can find additional information including: (1) What forms to file; (2) How to report revenue received in the final year of business; and (3) How to report expenses incurred before closure.

> **Comment:** Business owners can also get helpful information on declaring bankruptcy, selling their business and terminating retirement plans. **(Misc.; Business Terminations)**

☞**Steps Sole Proprietors Should Take When Closing Their Business (IRS Pub. 5447)**

The IRS has provided on its **website** guidance to sole proprietors on the specific steps they should take when closing (i.e., liquidating) their business.

> **Comment:** Due to the economic fallout caused by the current Covid-19 pandemic, this might unfortunately be a more common occurrence for many businesses going forward unless more stimulus payments or PPP loans are approved by Congress.

An employer who otherwise has employees and who goes out of business or ceases to pay wages must file *final* employment tax returns (e.g. **Form 941, Employer's Quarterly Federal Tax Return or Form 944, Employer's Annual Federal Tax Return, and Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return**). These returns must be marked "final return." (**Reg. §31.6011(a)-6(a)(1)**)

On **Form 941**, this is done by checking the box in **Part 3** and entering the date the employer last paid wages on line 17. (**Form 941, Instructions**)

On **Form 944**, it is done by checking the box in **Part 3** and entering the date the business closed or last paid wages on line 14. (**Form 944, Instructions**)

On **Form 940**, it is done by checking **Box d** on page 1 of the form. (**Form 940, Instructions**).

A final **Form 941** must be accompanied by a statement indicating where the employment tax records will be kept and the name and address of the new owner of the business, if any. If there was no sale or transfer of the business, or the employer does *not* know the name of the person who bought or acquired the business, that fact should be included in the statement. (**Reg. §31.6011(a)-6(b)**)

Form 1099-NEC, Nonemployee Compensation is used by businesses to report payments to non-employee workers (i.e., independent contractors). A business must file a **Form 1099-NEC** with the IRS for each non-employee worker to whom the business paid $600 or more and provide a copy to the nonemployee worker.

Generally, a business that operates a "large food or beverage establishment" must file **Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips**. A large food or beverage establishment is a "food or beverage operation:"

a. That is located in the U.S.,

b. Where customer tipping of food or beverage employees is customary, and

c. Normally employed more than 10 employees on a typical business day during the preceding calendar year (the "10-employee test").

A "food or beverage operation" is any business activity that provides food or beverages for consumption on the premises (e.g. a restaurant or a bar), other than fast food operations. Generally, tipping is *not* considered customary in a cafeteria-style operation or if at least 95% of total sales (other than carryout) had a service charge of 10% or more.

Closing a Sole Proprietorship: A sole proprietor should take the following steps when closing the business:

1. If the business has one or more employees, the employer should file final employment tax returns and make employment tax deposits for the calendar year in which the business makes its final wage payments. Employment tax returns include **Form 940**, **Form 941** and **Form 944**.

2. The employer will also need to provide employees with **Forms W-2, Wage and Tax Statement**, and **File Form W-3, Transmittal of Income and Tax Statements**, to transmit **Form W-2, Copy A**, to the Social Security Administration (SSA) for the calendar year in which the business makes its final wage payments.

Forms W-2 can be filed electronically using the **SSA's Business Services Online (BSO)** filing portal. Electronically filed **Forms W-2** do *not* need to be transmitted using a **Form W-3**. Federal tax deposits must be made using the Electronic Federal Tax Payment System (EFTPS). Both the BSO and EFTPS require registration before they can be used to file documents or make payments, respectively.

3. If the business paid any non-employee workers (i.e., independent contractors) $600 or more, it will need to provide them with **Forms 1099-NEC** and, if *not* e-filing its **Forms 1099-NEC**, the business will need to use **Form 1096, Annual Summary and Transmittal of U.S. Information Returns**, to transmit paper copies of **Forms 1099-NEC** to the IRS. **Forms 1099-NEC** can be filed electronically using the **IRS's Filing Information Returns Electronically (FIRE)** system.

4. If the business is a "large food or beverage establishment" and has tipped employees, the business should file **Form 8027** to report final tip income and allocated tips.

5. If the business provided its employees with a pension or benefit plan, the business will need to file a final **Form 5500, Annual Return/Report of Employee Benefit Plan**. **Form 5500** and **Form 5500-SF, Annual Return/Report of Employee Benefit Plan Short Form**, must be filed *electronically*. **Form 5500-EZ, Annual Return of One Participant (Owners and their Spouses) Retirement Plan**, cannot be electronically filed and, therefore, must

be filed on paper with the IRS.

6. File the final **Schedule C/F**. With either **Form 1040** or **Form 1040-SR**, a sole proprietor should file a final **Schedule C** or **F** to figure any profit or loss from the business. A **Schedule SE, Self-Employment Tax**, should also be filed if any self-employment tax is due. If the sole proprietor sold all of the business assets, including any goodwill, they should also attach to the return **Form 8594, Asset Acquisition Statement**. If the sole proprietor sold separate business assets or property, they should attach to the return **Form 4797, Sale of Business Property**.

7. The business's account with the IRS should be closed. After all their returns are filed, the sole proprietor should send the IRS a letter with the business's complete legal name, employer identification number (EIN), and business address, explaining why the business wants to close its account. Include a copy of the business's **SS4 letter** containing its EIN assignment (also known as a **147C letter**). Send the letter to: **Internal Revenue Service, Cincinnati, Ohio 45999**. All appropriate tax returns must be filed before the IRS will close the business's account. **(Misc.; Business Termination)**

Code §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:

☞Properly Calculating One's Level of "Insolvency" for COD Exception

Code §61(a)(12) clearly includes the forgiveness of debt as an item of gross income. However, **Code §108** provides a number of exceptions including insolvency which allow a taxpayer to avoid picking up this gross income otherwise reported on Form 1099-C. Nevertheless, the level of insolvency must be sufficient to cover the entire amount of the COD income (i.e., if a complete exclusion is to be claimed). And, in making this determination, IRS **Pub. 4681** makes it clear that in calculating insolvency, assets include everything you own, including "exempt assets which are beyond the reach of your creditors under the law, such as your interest in a pension plan and the value of your retirement account." As a result, it will be a great deal more difficult to claim this exception if one has to include assets owned through an IRA or a qualified retirement plan such as a 401(k) or a 403(b). **(Code §108; COD Income)**

Code §121 - Exclusion of Gain From Sale of Principal Residence:

☞Partial Exclusion Available for Gain on Sale of Principal Residence

Some sales of main homes are eligible for a *partial* exclusion of gain. This comes into play where the taxpayer otherwise has failed to meet the normal two-year use and residency tests (i.e., when looking at any of the 24 months, whether consecutive or not, during the 60-month period leading up to the actual date of the sale). The result is that the percentage of the $500,000 or $250,000 gain exclusion that can be taken is equal to the portion of the two-year period that the seller actually used the home as a principal residence. Some of the special

circumstances that might come into play include a sale of the home that resulted in a job change, as well as an illness (e.g., elderly parent has to be moved into a nursing home) or "unforeseen circumstances" qualify (e.g., a divorce where the newly wed couple has only lived in their new home for less than 24 months). **(Code §121; Home Sale Exclusion)**

Example: "Calculation of Partial Sec. 121 Gain Exclusion"

A married couple purchased a home for $500,000 in August of 2020, lived in it for 19 months and sold it in February of 2022 for $750,000 due to the fact that one of the spouses had secured a new employment position that was located in a distant state. The maximum gain exclusion in this instance is $395,833 ($500,000 x (19/24)) which would be more than enough to cover the $250,000 gain. Note also that either actual days living in the home instead of months can be used for this calculation.

Comment: IRS Pub. 523 contains a good bit of detailed information regarding the sale of one's home.

☞Reduced Homesale Exclusion for Nonqualified Use Necessitates More Recordkeeping for Certain Sellers
The "Housing Assistance Tax Act of 2008" includes a couple of breaks for residential real estate; namely, a new tax credit for "first-time" homebuyers and a new property tax deduction for non-itemizing homeowners. It also contains a controversial new restriction on the **Code §121** exclusion. The restriction is intended primarily as a device to restrict or eliminate tax-free homesale profits for those who use the exclusion once on a principal residence sale and then convert a vacation home to principal residence use and sell the second home for another tax-free homesale profit (i.e., after waiting for the necessary 2-year period of use as a principal residence). However, because of the complex new restriction on "nonqualified use," it could cause significant headaches for those selling homes after 2008, including those situations where the taxpayer never owned more than one home.

Background: Under **Code §121(a)**, a taxpayer can exclude from income up to $250,000 of gain from the sale of a home owned and used by the taxpayer as a principal residence for at least 2 of the 5 years before the sale. The full exclusion does *not* apply if, within the 2-year period ending on the sale date, the exclusion was taken in regard to another home sale by the taxpayer. Married taxpayers filing jointly for the year of sale may exclude up to $500,000 of homesale gain if: (1) *either* spouse owned the home for at least 2 of the 5 years before the sale, (2) *both* spouses used the home as a principal residence for at least 2 of the 5 years before the sale, and (3) neither spouse is ineligible for the full exclusion because of having claimed it within the prior two years. Nevertheless, the homesale exclusion does *not* apply to gain attributable to post-May 6, '97, depreciation claimed for either rental or business use of a principal residence. Also, a reduced maximum exclusion may apply to taxpayers who sell their principal residence but: (1) fail to qualify for the 2-out-of-5-year ownership and use rule, or (2) previously sold another home within the two-year period ending on the sale date of the current home in a transaction to which the exclusion applied. But, if the taxpayer's failure to meet either rule occurs because he must sell the home due to a change of place of employment, health, or to the extent provided by regs, other unforeseen circumstances, then he may be entitled to a reduced maximum exclusion. Under these circumstances, the maximum gain that can be excluded is equal to the full $250,000 or $500,000 exclusion times a fraction. Its numerator is the *shorter* of (a) aggregate periods of ownership and use of the home by the taxpayer as a principal residence during the 5 years ending on the sale date, or (b) the period of time after the last sale to which the exclusion applied, and before the date of the current sale. The denominator is 2 years (or its equivalent in months).

Restriction Due to "Nonqualified Use:" For sales and exchanges *after* Dec. 31, 2008, the **Code §121(a)** rule excluding homesale gain will *not* apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of "nonqualified use." (**Code §121(b)(4)**) Generally, nonqualified use is any period (other than the portion of any period *before* Jan. 1, 2009) during which the property is *not* used as the principal residence of the taxpayer or spouse. For example, use of a residence as rental property or as a vacation home would be considered "nonqualified use" (subject to some exceptions discussed below).

Comment: It should be noted that it is *not* the otherwise allowable exclusion that is reduced for nonqualified use. Instead, it is the actual gain potentially eligible for the exclusion. As a result, if the homesale gain is otherwise large enough, the seller may be able to use the full homesale exclusion despite extensive periods of nonqualified use.

Example: A single taxpayer buys a residence *after* 2008, uses it as a vacation home for four years, and then uses it as a principal residence for four years. If he then sells the home and a realizes a gain of $500,000, half of the gain will be allocable to nonqualifying use and subject to tax as long-term capital gain, but the other half will qualify for the full $250,000 homesale exclusion.

How to Allocate to Nonqualified Use: For determining the amount of gain that is allocated to periods of "nonqualified use," gain will be allocated to periods of nonqualified use based on the ratio which:

- the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, bears to;

- the total period that the property was owned by the taxpayer. (**Code §121(b)(4)(B)**)

According to the technical language contained in the Committee Reports, gain allocated to periods of "nonqualified use" is the total amount of gain multiplied by a fraction: (1) the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer, and (2) the denominator of which is the period the taxpayer owned the property.

Example: Mary, a single taxpayer, bought a home on Jan. 1, 2009, for $400,000, and uses it as rental property for two years claiming $20,000 of depreciation deductions (thereby reducing his basis in the home to $380,000). On Jan. 1, 2011, she converts the property to her principal residence. On Jan. 1, 2013, Mary moves out of the home and sells it for $700,000 on Jan. 1, 2014, and thus has a gain of $320,000 ($700,000 - $380,000). Under pre-Act law, Mary would have had $20,000 of gain attributable to depreciation deductions included in income (taxed at 25% as "unrecaptured section 1250 gain"), and would have excluded $250,000 of his gain (because she had two full years of ownership). The $50,000 balance of her long-term gain would have been taxed at a maximum rate of 15%. Under change made by the Housing Act, the *same* $20,000 of gain attributable to Mary's depreciation deductions is still included in income (i.e., taxed at 25% as "unrecaptured Sec. 1250 gain). Then, of the remaining $300,000 gain, 40% (2 years ÷ 5 years), or $120,000, is allocated to "nonqualified use" and is *not* eligible for the exclusion (and is taxed at maximum rate of 15%). The remaining gain of $180,000 is excluded under **Code §121**, since it is less than the maximum excludible gain of $250,000. As a result, the new law change costs Mary $10,500 (.15 × $70,000).

Comment: Presumably, the fraction will be expressed in *either* days or months in the same manner as the fraction that applies for determining the amount of the reduced exclusion for certain taxpayers failing to meet the ownership and use requirements or for taxpayers who have sold or exchanged principal residences within two years.

Comment: It is important to remember that a period of "nonqualified use" (as used in the numerator in the fraction above) will *not* include any period *before* Jan. 1, 2009. But, the denominator (i.e., the period that the taxpayer has owned the property) will include periods of ownership *before* Jan. 1, 2009. Thus, at least the law will *not* have a retroactive impact. But, clients will should either sell such properties *before* 1/1/2009, or at least consider the impact of these changes to any property that they may be considering converting and then selling *after* 2008.

Definition of "nonqualified use:" Generally, nonqualified use is any period (other than the portion of any period *before* Jan. 1, 2009) during which the property is *not* used as the *principal* residence of the taxpayer or spouse.

Comment: After buying an existing residence, a taxpayer may take an extended period of time to remodel, improve and/or enlarge it before he actually moves into the home and begins to use it as a principal residence. During that remodeling period, some commentators have expressed the concern that the taxpayer would *not* be considered to be using the residence as his principal residence. As a result, an argument could be made that the remodeling period could be construed to be a period of "nonqualified use" under **Code §121(b)(4)(C)(i)**. Certainly, it is issues such as this one which should be addressed by the IRS in future guidance.

Comment: Under **Reg. §1.121-1(b)**, another issue that might arise is whether a property is actually being

used as a "principal residence" based on the underlying facts and circumstances. For instance, if a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's "principal residence." Nevertheless, this "majority of the time test" is *not* dispositive if other relevant factors indicate that another residence is the taxpayer's principal residence.

"Nonqualified use" does *not* include use that falls into one of the following three categories:

(1) Post-principal-residence use: "Nonqualified use" does *not* include any portion of the **Code §121(a)** 5-year period which is *after* the last date that the property is used as the principal residence of the taxpayer or spouse. (**Code §121(b)(4)(C)(ii)**)

Example: Marc buys a principal residence on Jan. 1, 2009 and moves out on Jan. 1, 2019. On Dec. 1, 2021, he sells the property and realizes a $200,000 gain, *all* of which will be excluded from gross income. The property's use following Marc's departure from the property (e.g., as rental or vacation property, or vacant and held for sale) will *not* affect the otherwise allowable exclusion amount.

Comment: The bottom line is that, in order to qualify for the full homesale exclusion under the **Code §121(a)** two-out-of-five year ownership and use rule, the nonqualifying use *after* the owner leaves his principal residence is still *not* allowed to exceed three years (i.e., 36 months, or the 2/5 test would never be satisfied). Instead, the new law is focused upon properties that are converted after 2008 to principal residences *after* being used for some other purpose such as rental or vacation property.

(2) Qualified official duty exception: Nonqualified use does *not* include any period (not to exceed an aggregate period of 10 years) during which the taxpayer or spouse is serving on "qualified official extended duty." (**Code §121(b)(4)(C)(ii)**) Qualified official extended duty means duty as a member of the uniformed services or the Foreign Service, or as an employee of the intelligence community. (**Code §121(b)(4)(C)(ii)(II)**)

Example: Ellen buys a house in Virginia in Year 3 (a year beginning *after* Dec. 31, 2008) that she uses as her principal residence for three years. For eight years, from Year 6 through Year 14, Ellen serves on qualified official extended duty as a member of the Foreign Service in Germany. In Year 15, Ellen sells the Virginia house. She elected to suspend the ownership and use five-year testing period for the **Code §121** exclusion during her eight-year period of service in Germany (i.e., qualified official extended duty). As a result, the eight-year period is *not* counted in determining whether Ellen used the house for two of the five years preceding the sale for purposes of the homesale exclusion (including the amount of gain allocated to periods of nonqualified use).

(3) Temporary absence exception: A period of nonqualified use will *not* include any other period of "temporary absence" (defined as a period not to exceed an aggregate of two years) due to change of employment, health conditions, or any other unforeseen circumstances as may be specified by the IRS. (**Code §121(b)(4)(C)(ii)(III)**)

Example: On Jan. 1, Year 2 (a year beginning after Dec. 31, 2008), Rhonda, a resident of New York, buys a house in Minnesota that she intends to use as her principal residence. Before she can move into the Minnesota house, Rhonda is seriously injured in an accident on Feb. 1, Year 2 and is unable to move to Minnesota until Jan. 1, Year 4. For the next three years (until Dec. 31, Year 7), she lives in the Minnesota house. On Jan. 1, Year 7, Rhonda sells the Minnesota house. Presumably, Rhonda's absence from the Minnesota house will qualify for the temporary absence exception because the absence did *not* exceed an aggregate period of two years and was due to a change in health conditions (and also might have been due to "unforeseen circumstances").

Comment: In this instance, the language of the temporary absence exception is similar to the circumstances described in **Code §121(c)(2)(B)** that qualify for the reduced maximum exclusion (i.e., conditions stemming from a change in place of employment, health, or, to the extent provided in regs, unforeseen circumstances).

Coordination With Recognition of Gain Attributable to Depreciation: For determining the amount of gain allocated to nonqualified use of a principal residence, the following rules apply:

- the rule providing that gain allocated to periods of nonqualified use does *not* qualify for the exclusion is applied *after* the application of **Code §121(d)(6)** (i.e., rules providing that gain attributable to post-May 6, '97 depreciation does *not* qualify for the exclusion), and

- the rules providing for the allocation of gain to periods of nonqualified use are applied without regard to any gain to which **Code §121(d)(6)** applies. (**Code §121(b)(4)(D)**) **(Code §121; Home Sale Exclusion)**

> **Comment:** See the first example above where Mary sold her home for a $320,000 gain, of which $20,000 was "unrecaptured Sec. 1250 gain," and then the remaining $300,000 gain had to be prorated based on the fact that she had rented out her home for 2 years *before* using it as her principal residence for the next 3 years.

Code §163(h) - Qualified Second Residence:

☞**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**

☞**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:

☞**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 - Rental of Home Office to Employer:

☞**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 §401 - IRA/Pension Plans - Required Minimum Distributions:

☞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)**

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.

Code §469 - Passive Activity 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)**

☞**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).

> **Comment:** 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.

> **Comment:** 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 ***Candelaria*** 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 §1221 - Capital Asset Defined:

☞**Ordinary Loss for Abandonment of Leasehold Improvements**

When, at the end of a lease term, the lessee decides to abandon leasehold improvement whose costs have *not* been fully recovered (i.e., under the MACRS system), a **Code §1231** loss can be claimed on Form 4797 for any remaining basis in the underlying assets. And, if this **Code §1231** loss exceeds any **Code §1231** gains for the tax year in question, then the excess is taken on page one of the taxpayer's return as an ordinary loss. **(Code §1231; Leasehold Improvements)**

> **Comment:** Remember that certain leasehold improvements (QIP) made after 12/31/17 may qualify for a 15-year write-off instead of the normal 27.5- or 39-year classification for real estate. More importantly, there might be little or no remaining adjusted basis in such assets given that Sec. 179 or 100% bonus depreciation was used to write of their cost. As a result, there might not be any "loss" when these assets are abandoned.

Code §1361 - Electing S Corp Status:

☞**Careful Planning Needed for LLCs Elect S Corp Status**

Although the self-employment tax savings can be powerful tax incentive when considering the conversion of an LLC taxed as a partnership to an S corporation, careful consideration should be given to those situations where guaranteed debt has been used as additional at-risk basis for taking partnership K-1 losses. The key factor is that this additional basis will immediately be lost since, under the S corporation basis rules, guaranteed debt is *not* counted (at least not until actual payments have to be made by the guarantor). Instead, only "direct shareholder loans" can be used to create additional basis beyond any stock basis (which is derived from original, as well as additional, capital contributions, along with net income to-date).

> **Comment:** Other reasons for an LLC to make an S election might be to avoid the imposition of either the .9% or the 3.8% Medicare surtaxes (i.e., by instead making distributions of S corp profits), or simply because these partners would rather be able to take W-2 payroll v. having to receive guaranteed payments (i.e., and thus avoid, perhaps, having to make estimated tax payments throughout the year while also only having to pay the *employee's* share of payroll taxes instead of self-employment tax).

> **Comment:** A critical planning step where guaranteed debt has been used as additional at-risk basis is to do a "novation" whereby the guarantor becomes the *primary* obligor instead of merely remaining a *secondary* obligor (who the lender looks to only when the entity has failed to make sufficient payments on the outstanding principal balance). However, many lenders do not understand this concept of "novation" even though it leaves them in the *same* position of security with regard to the debt (i.e., they have *both* the entity as well as the owners to go after for full repayment of the debt).

Another possible tax trap can be the used of "qualified nonrecourse real property indebtedness" as additional basis in those instances where the LLC holds real estate which is subject to a mortgage. Once again, the tax law contains a loophole (which was negotiated many years ago by the real estate tax shelter lobbyists) that despite no one being personally liable for the repayment of the mortgage, it is nevertheless counted as additional "at-risk basis" (as shown on **Form 6198**) for taking K-1 losses.

The bottom line is that if either if these exceptions have been used to create additional at-risk basis for taking losses, **Code §465(e)** will apply and result in"at-risk recapture." This, in turn, means that these new S corp shareholders will have immediate income recognition to the extent that they no longer have this basis for taking the earlier partnership losses that had previously flowed through to them on their respective K-1s.

> **Comment:** The character of the income needing to be picked up in the owner's income is dependent upon the character of the loss that had previously been taken.

On a separate note, another key consideration on making the switch from LLC partnership status to that of an S corporation is "negative capital accounts." For instance, a partner who has guaranteed a debt can use this additional "soft basis" for taking a distribution that is in excess of the "hard basis" (i.e., that basis derived from

capital contributions along with their share of any K-1 net income to-date) that they otherwise have in their partnership interest. In fact, *all* liabilities, even if they are *not* "at-risk" (e.g., nonrecourse debt) count for basis when determining whether a partner has sufficient basis with regard to the possible taxation of a distribution. In other words, there is no need to fill out **Form 6198** in order to determine "at-risk basis" when a distribution is made and whether or not it is taxable to the partner receiving it.

Again, when the S election becomes effective for a former LLC taxed as a partnership, the rules for capital accounts do *not* permit an S corp shareholder to have a "negative" balance. As a result, any shareholder who as a former partner had a deficit in their capital account would now have to pick up that excess as income in the first year of the S corporation's existence.

One final note concerns LLCs where there is plenty of income to cover distributions but with only some partners taking distributions while other partners do not. For instance, consider a profitable accounting firm equally owned by two partners, Steve and John. Over the course of several years, Steve has drained his share of the firm's profits to the extent of his share of K-1 income. Meanwhile, John has only extracted his share of the firm's profits to the extent needed to cover his estimated income tax liability. If this situation is *not* rectified by the time that the S election takes effect (i.e., by John taking a corresponding amount of distributions out of the LLC to even out the situation with his partner Steve), then the general rule that all S corp distributions be pro rata will come into play.

> **Comment:** It is one thing to allow a disproportionate distribution to "make up" for prior mistakes in this area (or, where state or local income taxes have to be deposited on behalf of nonresident shareholders), but to cause an S corp to make significantly larger disproportionate distribution so as to make up for sizable unequal distributions from prior years as a partnership would be very hard to defend.

> **Comment:** Another completely separate issue should also be considered when choosing to convert an LLC taxed as a partnership to an S corporation. Namely, the various types of ownership units a partnership entity might have outstanding. Differences in voting rights are permitted should a switch be made to S corp status. But, any other distinctions among the partners' respective interests would have to be resolved before the effective date of the S election since only one class of common stock is permitted. And, as far as what would be the initial basis of their S corp stock for tax purposes, it would most likely be whatever the final basis in their partnership interest had been, adjusted for the possible scenarios mentioned above.
> **(Misc.; Capital Accounts)**

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.

Example: "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.

Comment: 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 **Code §1374** "built-in gains" tax.

Example (Cont'd.): 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.

Comment: 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.

Example: "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.

Example: "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 **Form 8582** given that he does *not* have sufficient passive income).

The taxpayer in this instance clearly meets the tests as a **"real estate professional"** under **Code §469(c)(7)**. But, it would be difficult to prove that he materially participates in each and every one of his rental activities. As a result, a valid "grouping election" is made so that the various rental property are treated as just *one* activity for purposes of the passive loss rules. More importantly, given that he has already satisfied the 750-hour REP test, he would clearly satisfy the "500-hour"material participation test for this *one* activity under the PAL rules.

The bottom line is that he will save approximately $38,000 each year by *not* having to pay the 3.8% Medicare surtax on his $1 million of net rental income (i.e., which is now treated as being *nonpassive*).

Comment: Of course, if this taxpayer had significant passive losses in need of passive income to offset them, then consideration should be given to *not* making the "grouping election" and instead net most (if not all) of what would now be passive rental income with these passive losses (i.e., thus, *not* subjecting any net rental income to the surtax, while also being able to currently deduct his other passive losses).

Comment: Maybe the even bigger consideration from a tax standpoint of making the "grouping election" and having *not* only the net rental income each year *not* be subject to the surtax, is that any Sec. 1231 gain on the sale of these properties would even be much greater and would also escape the surtax.