Monthly Tax Update

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INDIVIDUAL TAXATION:

☞PTET Option Costing IRS Billions in Lost Revenue

Thirty-six states now offer passthrough entity owners workarounds for the SALT cap. However, it is estimated that the federal government is losing out on approximately $10 to $15 billion a year, according to a nonpartisan tax think tank. Under the state "passthrough entity tax" election, partnerships and S corporations can elect to pay an entity-level state income tax (i.e., which is deducted on page one of either **Form 1065** or **Form 1120S**) instead of having the owners pay state tax on income that is passed through to them via their K-1s. 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.

As a result of these state workarounds, the SALT cap, which was a key revenue raiser in the 2017 tax law, is generating only about 85% of its originally projected revenue. **(Code §164; PTET)**

IRS Reminder to Check Legitimacy of Charitable Donees

The IRS has again issued their annual warning to taxpayers "to be wary of criminals soliciting donations and falsely posing as legitimate charities." The Service is reminding taxpayers that "when unsuspecting donors choose to give funds to these fake charities, the proceeds do not go to those in need, and the donations cannot get deducted on the taxpayers' personal tax returns." Those who wish to make donations should use the **Tax-Exempt Organization Tool (TEOS)** on the IRS's **website**. This tool can help taxpayers verify the legitimacy of a charity, check its eligibility to receive tax-deductible charitable contributions, and search for information about an organization's tax-exempt status and filings. **(Code §170; Charitable Donations)**

> **Comment:** The IRS is also urging anyone who encounters a fake or suspicious charity to review the FBI **website** regarding resources on charity and disaster fraud.

☞**Key Busy Season Statistics (Audit No. 2024-400-006)**

A recent TIGTA audit report highlighted some interesting tax statistics regarding the 2022 return busy season as follows:

- 141,100,000 individual tax returns were filed so far in 2023 with the IRS expecting 167,000,000 by yearend.

- 260 different "filters" were used by the IRS to detect and identity theft. By using them, the IRS confirmed 87,591 tax returns as fraudulent and prevented $1.2 billion in fraudulent refunds.

- 1,800,000 Identity Protection Personal Identification Numbers (IPPINs) were issued to taxpayers. It is a six-digit number the IRS offers that helps taxpayers prevent someone else from filing a tax return using their Social Security Number.

- There are 363 IRS "walk-in sites" (i.e., Taxpayer Assistance Centers or TACs) to help taxpayers. At the time of this review, 22 TACs were still closed because of staffing issues. Furthermore, 157 TACs have just one or two employees.

- 570,596 taxpayers initially thought they needed to visit a TAC to get help. Instead, the IRS was able to help them over the phone. **(Misc.; Tax Statistics)**

Propose Regs Deny Deductions for Certain Conservation Easement Contributions (REG-112916-23)

Treasury and the IRS have issued proposed regulations that provide guidance under a new section of the **law** that disallows deductions for certain charitable conservation contributions by partnerships and other pass-through entities. Syndicated conservation easements have been included in the IRS' annual list of **Dirty Dozen** tax schemes for many years. **(Code §170; Conservation Easements)**

S CORPORATIONS:

S Corporation Status Preserved During Bankruptcy (*Vital Pharmaceuticals*, No. 3D22-582 (D.C., Fla., 8/24/2022))

The District Court confirmed that a company's S-corporation tax status must be preserved during the course of a bankruptcy proceeding. After an S corporation filed for bankruptcy, and shortly before a forced sale of the company's assets was scheduled to take place, the sole owner petitioned the bankruptcy court for relief so that he could revoke the debtor's S corp election. The reason behind this request was that he would *not* be taxed on the proceeds from the asset sale. But the company and the unsecured creditors objected to the shareholder's request. The bankruptcy court agreed that the owner should *not* be permitted to revoke the S election, because the debtor's S-corporation status "was property of the bankruptcy estate." **(Code §1361; Bankruptcy)**

TRUSTS, ESTATES & GIFTS:

☞**New SEC Requirement for EINs on Revocable Grantor Trusts**

It is *not* an IRS requirement but an SEC **rule** for brokerage houses. The due date is May 31, 2024. The intention is to be able to match transactions, but the trust names are *not* necessarily matching the account beneficiaries in some cases, causing surveillance issues. **(Code §671; Grantor Trusts)**

> **Comment:** Revocable living trusts are a common way to avoid the publicity of having to go through probate by having the decedent's assets passed to their heirs by operation of contract law. And, during their lifetime, the existence of the trust for income tax purposes is simply ignored with the grantor being treated as responsible for any tax consequences. As a result, the grantor's SSN is used to for **Form 1099-B** purposes, along with any dividend or interest income also flowing to their personal return.

> **Comment:** The brokerage firms are having some difficulty in figuring out how they want to implement this new requirement (especially in light of the upcoming "beneficial ownership reporting information" rules). But this new SEC rule requires the brokerage firm to figure out a way to have a unique identifier for all trades. This is why they are requiring some client to get an EIN for a grantor trust.

> **Comment:** With regard to the **Corporate Transparency Act (CTA)** and an entities mandated to report their beneficial ownership information (BOI) to the Financial Crimes Enforcement Network (FinCEN), the AICPA has stated that "CPAs should be careful in advising and/or filing BOI reports on their clients' behalf." They state that it is *not* clear

whether advising/filing on a clients' behalf constitutes the "unauthorized practice of law" since it is *not* part of the Internal Revenue Code. In response, one could argue that there are many instances where practitioners are required to submit various information items to the IRS, even though it might *not* be specifically covered under a Code section.

RETIREMENT PLANS & FRINGE BENEFITS:

☞Failure to File Form 1095-C Results in Costly Penalties

The IRS is pursuing employers that have failed to comply with Obamacare reporting. Specifically, companies with 50 or more "full-time-equivalent employees" are required to file **Form 1095-C** each year to report annual health insurance data for each full-timer to both IRS and the worker. They are also required to annually file **Form 1094-C**. The IRS is asserting penalties on employers who filed late or incorrect health forms. Some employers who filed the forms on time but made errors can have the fines waived if they can demonstrate that they made "a good-faith effort to comply with the rules." But the penalties can be substantial with up to $310 per employee for 2024 filings. The penalty can be $630 or even higher for employers who "intentionally disregard the rules." **(Code §6722; Form 1095-C)**

> **Comment:** A school district in Va. has been fined for failing to file these healthcare forms for 2019. The IRS is claiming the school district owes over $2 million in penalties and interest and has placed a lien against one of the schools for nonpayment of the deficiency. In response, the school district has filed a petition in Tax Court opposing IRS's collection activities.

☞401(k)/403(b) Limit Increases to $23,000 for 2024, IRA Limit Rises to $7,000 (Notice 2023-75)

The IRS has released the cost-of-living inflation adjustments which will impact the 2024 tax year amounts as follows:

- The amount individuals can contribute to their 401(k) or 403(b) plans in 2024 has increased to $23,000, up from $22,500 for 2023.

- The limit on annual contributions to an IRA increased to $7,000, up from $6,500.

- The IRA catch-up contribution limit for individuals aged 50 and over was amended under the **SECURE 2.0 Act of 2022** to include an annual cost of living adjustment but nevertheless remains $1,000 for 2024.

- The catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), and most 457 plans, as well as the federal government's Thrift Savings Plan remains $7,500 for 2024. Therefore, participants in 401(k), 403(b), and most 457 plans, as well as the federal government's Thrift Savings Plan who are 50 and older can contribute up to $30,500, starting in 2024.

- The catch-up contribution limit for employees 50 and over who participate in SIMPLE IRA plans remains $3,500 for 2024.

- The income ranges for determining eligibility to make deductible contributions to traditional IRAs, to contribute to Roth IRAs, and to claim the Saver's Credit all increased for 2024.

- As was the case in prior tax years, taxpayers will be able to deduct contributions to a traditional IRA if they meet certain conditions. If during the year either the taxpayer or the taxpayer's spouse was covered by a retirement plan at work, the deduction may be reduced, or phased out, until it is eliminated, depending on filing status and income.

> **Comment:** If neither the taxpayer nor the spouse is covered by a retirement plan at work, the phase-outs of the deduction do *not* apply.

- The following are the phase out ranges for making deductible IRA contributions for 2024:

(1) For single taxpayers covered by a workplace retirement plan, the phase-out range is increased to between $77,000 and $87,000, up from between $73,000 and $83,000.

(2) For married couples filing jointly, if the spouse making the IRA contribution is covered by a workplace retirement plan, the phase-out range is increased to between $123,000 and $143,000, up from between $116,000 and $136,000.

(3) For an IRA contributor who is *not* covered by a workplace retirement plan but is married to someone who is covered, the phase-out range is increased to between $230,000 and $240,000, up from between $218,000 and $228,000.

(4) For a married individual filing a separate return who is covered by a workplace retirement plan, the phase-out range is *not* subject to an annual cost-of-living adjustment and remains between $0 and $10,000.

- The following are the phase out ranges for making Roth IRA contributions for 2024:

(1) The income phase-out range for taxpayers making contributions to a Roth IRA is increased to between $146,000 and $161,000 for singles and heads of household, up from between $138,000 and $153,000.

(2) For married couples filing jointly, the income

phase-out range is increased to between $230,000 and $240,000, up from between $218,000 and $228,000.

(3) The phase-out range for a married individual filing a separate return who makes contributions to a Roth IRA is *not* subject to an annual cost-of-living adjustment and remains between $0 and $10,000.

Comment: Even though an individual cannot make a *deductible* IRA contribution, everyone (i.e., regardless of their modified AGI) is permitted to make a *nondeductible* contribution to their IRA (i.e., by also including **Form 8606** when filing their personal return). Then, depending on whether they otherwise have a zero balance in their IRA, they can convert this nondeductible contribution amount over to their Roth IRA (i.e., make a "back-door Roth IRA contribution") at no additional tax cost. In the **"Build Back Better" (BBB)** proposed legislation several years ago, this strategy was going to be shut down, but the bill died in the Senate.

- The income limit for the Saver's Credit (also known as the Retirement Savings Contributions Credit) for low- and moderate-income workers is $76,500 for married couples filing jointly, up from $73,000; $57,375 for heads of household, up from $54,750; and $38,250 for singles and married individuals filing separately, up from $36,500.

- The amount individuals can contribute to their SIMPLE IRA retirement accounts is increased to $16,000, up from $15,500 (i.e., $19,500, if eligible for the additional $3,500 catch-up amount).

Comment: Yet, this $19,500 is a far cry from the $30,500 that can put aside for a 401(k) or 403(b) plan.

Additional changes made under **SECURE 2.0** are as follows:

- The limitation on premiums paid with respect to a "qualifying longevity annuity contract" to $200,000. For 2024, this limitation remains $200,000.

- Added an adjustment to the deductible limit on charitable distributions (QCDs). For 2024, this limitation is increased to $105,000, up from $100,000.

- Added a deductible limit for a one-time election to treat a distribution from an IRA made directly by the trustee to a "split-interest entity" (e.g., CRATs, CRATs or CGAs). For 2024, this limitation is increased to $53,000, up from $50,000. **(Misc.; 2024 Retirement Plan Changes)**

☞**Tax Court's Jurisdiction Over IRS Denial of 60-Day IRA Rollover Rule (Estate of James E. Caan, 161 TC No. 6 (10/182023))**

In a case of first impression, the Tax Court held that it has jurisdiction under **Code §6213(a)** to review the IRS's denial of a taxpayer's request for a "hardship waiver" of the 60-day period for rollover IRA contributions. It also held that it reviews a denial of a request for a waiver under **Code §408(d)(3)(I)** for abuse of discretion. **(Code §408; IRS Distributions)**

Comment: The actor James Caan received a distribution from his IRA and failed to do a tax-free rollover within the mandatory 60-day period into another IRA or qualified retirement plan. As a result, he had to include the distributed amount in his gross income for the tax year in question. Also, he did *not* re-contribute the same property that was originally distributed. He sold the investment property and then rolled over the cash realized on the sale.

Comment: In this case, the IRS did *not* "abuse its discretion" in denying the taxpayer a waiver because it cannot be an abuse of discretion for the IRS to deny a waiver where granting the waiver would *not* have helped him in any way. He had already converted the partnership interest (which was the subject of the original IRA distribution) to cash. As a result, there was no way to roll over the cash, even if it had occurred *before* the 60-day rollover period expired.

Comment: The IRS offers relief if you deposit the withdrawn funds to an IRA after the 60-day period. Under **Rev. Proc. 2016-47** taxpayers are permitted to "self-certify" that they qualify for a waiver of the 60-day rule in certain cases. The late rollover must be for one of 11 stated reasons and completed within 30 days after the specific reason for failing to do it timely in the first place ceases. Also, keep in mind that you are required to roll over the *same* property originally distributed from the IRA. For example, if you took a cash distribution, then cash must be deposited in a rollover. If the payout was 100 shares of IBM stock, those same shares must be put back. Finally, the "60-day rollover rule" can only be used once within a 12-month period unless it is an IRA-to-IRA direct transfer (i.e., since these transfers are *not* considered to be a "rollover distribution").

Comment: More people are making hardship withdrawals from their 401(k) accounts and IRAs in order to cover emergency medical expenses, educational costs, or to avoid losing a home. For example, hardship withdrawals from Fidelity Investments 401(k) accounts have tripled in the last five years (i.e., starting in 2018, even before the onset of COVID-19 in 2019).

EMPLOYMENT TAXES:

IRS Encourages Employers to Electronically File Payroll Tax Returns (IR-2023-198)

The Service today reminded employers that the best way to file their quarterly payroll tax return is electronically. While paper filing is available, the IRS "strongly encourages e-filing" since it is "the most secure, accurate method to file returns, and saves time." E-filing is easy with auto-populating forms and schedules and a step-by-step process that performs calculations for the user. Also, the IRS acknowledges receipt of e-filed returns within 24 hours, "giving employers reassurance that their return was *not* misplaced or lost in the mail." E-file users also receive missing information alerts.

Options for Electronic Filing: There are two options when electronically file payroll tax returns. The first option for employers is "to self-file by purchasing IRS-approved software that meets their specific needs." There may be a fee to electronically file returns through the software, and the software will require a signature to e-file the returns.

Depending on the software they choose, employers will do one or both of the following: (1) Apply for an online signature PIN; or (2) Scan and attach **Form 8453-EMP, Employment Tax Declaration** for an IRS e-file Return, for the required signature. The second option for employers is "to hire a tax professional to prepare and file their employment tax returns." **(Code §3401; Payroll Returns)**

TAX-EXEMPT ENTITIES:

Checking Status of Tax-Exempt Application

If a group files either a **Form 1023** or **Form 1023-EZ** application for tax exemption status, the IRS website can give an update on the progress of the application. The Service receives almost 100,000 applications for tax-exempt status each year. Use **"Where's My Application for Tax-Exempt Status"** to view guidelines and dates on when you might hear from IRS. The tool also has a chart with the latest postmark date of application forms that have been assigned for review. **(Code §501(c)(3); Tax-Exempt Status)**

ADMINISTRATIVE & PROCEDURAL MATTERS:

☞Practitioners' Obligation to Have Written Information Security Plan

To fulfill their professional obligations, practitioners (i.e., attorneys, CPAs, EAs, and tax return preparers who participate in the **IRS Annual Filing Season Program**) must comply with **Circular 230, Regulations Governing Practice before the IRS**, which is administered and enforced by the IRS's **Office of Professional Responsibility (OPR)**.

Circular 230: Tax practitioners must possess the necessary competence to engage in practice before the IRS, and overall competence has been construed in related contexts to encompass technological competency. In addition, there is an obligation on practitioners who have or share the principal authority and responsibility for a firm's tax practice to have in place "adequate procedures" to ensure compliance by its members, associates, and employees (including independent contractors) with **Circular 230**. While *not* framed as a mandatory requirement (i.e., "must") but as an "aspirational standard" (i.e., "should"), **Circular 230** provides that tax advisors should adhere to "best practices" in providing advice and preparing or assisting in the preparation of a submission to the IRS, including compliance with **Circular 230's** standards of practice and the obligation to maintain client confidences.

FTC's Safeguards Rule: Practitioners are required to implement safeguards, including a "written information security plan" (WISP), to protect the security, confidentiality, and integrity of information. The Safeguards Rule also elaborates that companies covered by the rule are responsible for taking steps to ensure that their affiliates and service providers also safeguard customer information in their care. **IRS Pub. 4557, Safeguarding Taxpayer Data: A Guide for Your Business**, seeks to help tax professionals understand basic security steps and how to take them, recognize the signs of data theft and how to report data theft, respond and recover from a data loss, and understand and comply with the FTC Safeguards Rule.

Data Security Protocols: A well-constructed WISP should identify the risks of data loss for the various types of information handled by a firm or company and focus on employee management and training, information systems, and detecting and managing system failures. There is no static, "one-size-fits-all" solution to tax practitioners' data security challenges. Instead, a security plan should be scaled to the business's size, scope of activities, complexity, and the sensitivity of the customer data it handles and should be updated as business or technology changes dictate. In any event the IRS recommends, as a general matter, certain protocols should be considered by all tax practitioners:

- Do not collect more "Personally Identifiable Information" (PII) of clients than is necessary for your business operations, and do *not* retain PII longer than necessary or legally required for business purposes.

- Protect the PII you collect, use, disclose, and retain. For example, store PII in a locked room or file cabinets (with information secured at the end of each workday).

- Restrict access to PII to only those individuals with a business need to access the information.

- Dispose of PII appropriately, such as shredding documents and wiping (or, destroying) old hard drives, fax machines, printers, and other equipment.

- Use qualified and vetted contractors, including physical and data security consultants.

- Instill awareness and train employees (professional and nonprofessional alike) on properly handling PII.

- Establish security protocols for electronic programs and files, including server locks, password policies, guidance on phishing / malware schemes, and laptop and mobile device security.

- Develop and enforce email policies and procedures that comply with federal and state laws.

- Continually monitor computer networks to identify and redress potential security issues (e.g., software updates, anti-virus software, firewalls, security patches, scan engines).

- Establish guidelines related to Internet browsing, use of "smart" devices, and use of social media and professional networking sites.

- Maintain good records and have policies and procedures in place for what to do in case of a data breach (including timely notification of the business's insurance carrier).

- If your employees work remotely, adopt policies relating to the use of:

(1) Virtual private networks (VPNs) to securely conduct business;

(2) Separate personal and business computers, mobile devices, and email accounts; and

(3) "Smart" devices.

- Establish security policies related to physical files and other records kept at home.

Conclusion: Federal law, enforced by the FTC, requires tax preparers to create and maintain a written data security plan. Having a WISP protects businesses and their clients while providing a blueprint for action in the event of a security incident. In addition, a WISP can help if other events seriously disrupt a tax professional's ability to conduct normal business, including fire, flood, tornado, earthquake, and theft.

Failure to maintain a WISP to protect private financial information may not only put clients at risk for identity theft and fraud, it may also *expose a practitioner to liability* for violating the Safeguards Rule, as well as the terms of their malpractice insurance coverage. In addition, it could subject a practitioner, in circumstances of willfulness, to discipline under **Circular 230**. Given the competence requirement and the obligation imposed by section by **Circular 230** to have procedures in place to ensure compliance by everyone involved in a tax practice, the IRS is encouraging practitioners to pay heed to the requirement to adopt a WISP and implement appropriate data security programs. **(Misc.; Data Security)**

☞IRS Improves "Where's My Refund?" Online Tool

During the upcoming tax filing season, the IRS stated that taxpayers will benefit from important new updates to the **"Where's My Refund?"** tool, which is the Service's most popular customer service tool. In 2022, "Where's My Refund?" was used by 54 million taxpayers and generated 550 million hits. However, according to the Service, the current version of this IRS tool "provides limited information, often leading taxpayers to call the IRS to inquire about their refund status."

The updates to "Where's My Refund?" will allow taxpayers to see "more detailed refund status messages in plain language." These updates will also ensure "Where's My Refund?" "works seamlessly on mobile devices." Taxpayers often see a generic message stating that their returns are still being processed and to check back later. With the new and improved "Where's My Refund?", taxpayers will see "clearer and more detailed updates," including whether the IRS needs them to respond to a letter requesting additional information. The new updates will reduce the need for taxpayers to call the IRS for answers to basic questions.

- Example of current message: "Your tax return is still being processed. A refund date will be provided when available. For more information about processing delays, please see our Refund Frequently Asked Questions."

- Example of new and improved messages: Taxpayers will now see messages such as:

(1) "To protect you from identity theft, your tax return is currently being reviewed. To help us process your return more quickly, verify your identity and tax return information. If you recently received a letter from us, follow the instructions on the letter. Please have your tax return (Form 1040 series) available and read the website or letter before starting the verification process. If you already reviewed your identity and tax return information you may check the status of your refund in 2-3 weeks."

(2) "We received your return and sent you a letter requesting more information. Please respond by following the instructions in the letter. If you don't respond, your refund amount could be changed. It may take 2-3 weeks for you to receive the letter."

(3) "We have reviewed your return and any information we may have requested from you and are now processing your return. Any changes to the status of your refund, including any new refund date, will be reflected here when any new update is available." **(Misc.; Tax Refunds)**

IRS Announces Improvements for 2024 Filing Season (FS-2023-25)

Treasury Secretary Janet Yellen has announced that the first goal of the **IRS Paperless Filing Initiative** "has been met three months early." Taxpayers can now digitally submit all correspondence and responses to notices using the online **IRS Document Upload Tool**. The IRS anticipates digital submission of up to 125 million documents each year. The IRS plans to meet the second goal of the initiative by the start of the 2024 filing season by providing the option for taxpayers to e-file 20 additional tax forms, enabling up to 4 million additional tax returns to be digitally filed every year. Other planned improvements for the 2024 filing season include updates to the **Where's My Refund Tool** that will provide taxpayers "with more detailed information in plain language" while allowing the tool to work on mobile devices. The IRS will also add 8,500 in-person support hours at its **Taxpayer Assistance Centers** and plans to implement significant improvements to its taxpayer helpline. **(Misc.; IRS Improvements)**

☞**IRS Plans to Conduct Practitioner Survey (FS-2023-74)**

Between Nov 27, 2023, and Jan 19, 2024, tax professionals may be randomly selected to participate in a voluntary phone survey. The IRS is insisting that his is *not* a scam and are asking practitioners to "please *not* hang up." Responses are intended to help the Service "improve services to the tax pro community and the taxpayers they serve."

The survey will be conducted by ICF, an independent research firm hired by the IRS. It will take about 20 minutes to complete, and covers topics including e-filing, due diligence requirements, data security, and electronic document submission. All responses are anonymous and confidential. Tax professionals will *not* be asked to provide any personal info about themselves or their clients. If tax pros are contacted, it will be Monday through Friday between 8:30AM - 6:30PM local time and they will see a Kansas City (i.e., 816) area code on their caller ID. For more information or questions about the survey practitioners can email **TaxProfessional@icfsurvey.com** or call **(888) 504-6387**. **(Misc.; IRS Survey)**

☞**IRS Launches First Phase of New Business Tax Account (IR 2023-194)**

The IRS has launched the first phase of the "**business tax account**," enabling unincorporated sole proprietors who have an active Employer Identification Number to set up an account (i.e., so those Schedule C/F proprietors with no employees and using their SSNs would *not* be eligible), view their business profile and manage authorized users. Over time, the business tax account will allow business taxpayers to check their tax payment history, make payments, view notices, authorize powers of attorney and conduct other business with the IRS. Future improvements will allow taxpayers to use their business tax accounts to view letters or notices, request tax transcripts, add third parties for power of attorney or tax information authorizations, schedule or cancel tax payments and store bank account information. **(Misc.; Business Tax Accounts)**

☞**IRS Reminder on 2024 PTIN Renewal Period (IR 2023-197)**

The IRS is reminding the nearly 800,000 federal tax return preparers that they are required to renew their Preparer Tax Identification Numbers (PTINs) now for 2024. *All* current PTINs will expire on 12/31/23. Anyone who prepares (or, assists in preparing) a federal tax return for compensation must have a valid PTIN from the IRS before preparing returns. The PTIN needs to be included as the identifying number on any return filed with the IRS. All enrolled agents must also have a valid PTIN. The non-refundable fee to renew or obtain a PTIN is $19.75 ($11 application fee plus $8.75 to a third-party contractor; down from $30.75 in 2022) for 2024. Tax preparers with a 2023 PTIN are encouraged to use the **online renewal process**. Nevertheless, **Form W-12** is available for paper renewals with a processing time of approximately six weeks. Failure to have and use a valid PTIN may result in penalties. **(Misc.; PTINs)**

☞**IRS Makes Permanent E-Signature Rules for Certain Elections/Documents (IR 2023-199)**

The IRS has incorporated guidance on e-signatures into its updated **Internal Revenue Manual (IRM)**, making the acceptance of those signatures permanent. During the COVID-19 pandemic, the IRS issued temporary relief allowing taxpayers to electronically sign and submit certain documents. This temporary relief was set to expire on 10/31/23. The IRS has partially incorporated this waiver into the IRM, allowing taxpayers to use e-signatures on specified non-return documents, including extensions of the statute of limitations on assessment or collection, waivers of statutory notices of deficiency and consents to assessment, closing agreements, and any other statement or form needing the signature of a taxpayer or representative traditionally collected by the IRS personnel outside of standard filing procedures. Additionally, e-signatures will now be allowed on certain forms and returns that cannot be filed electronically. **(Misc.; E-Signatures)**

☞**New Energy Credit Online Tool for Sellers of Clean Vehicles (IR 2023-202)**

The IRS has announced that sellers of "clean vehicles" can now register using the new **IRS Energy Credits Online** tool, available free from the IRS. According to the IRS, this free electronic service "is secure, accurate and requires no special software." Though available to any business of any size, **IRS Energy Credit Online** "may be especially helpful to any small business that currently sells clean vehicles."

> **Comment:** The IRS is advising that clean vehicle sellers and dealers should register with **Energy**

Credits Online by Dec. 1, 2023 to ensure Jan. 1, 2024 availability. (**IR 2023-206**)

Background: The IRS's new **Energy Credits Online** tool "will allow dealers and sellers of clean vehicles to complete the entire process online and receive advance payments within 72 hours." The tool will also generate a "Time of Sale report" that the taxpayer will use when filing their federal tax return to claim or report the credit. "This special online tool is designed to help dealers and sellers navigate this important new Clean Vehicle Credit and help taxpayers at tax time," said IRS Commissioner Danny Werfel. "Online tools like this are part of the larger effort taking place at the IRS with **Inflation Reduction Act** funding to make improvements and better serve both taxpayers and businesses."

Filing Requirement: Beginning in 2024, clean vehicle sellers and licensed dealers will be required to use the tool for their customers "to successfully claim or transfer the new or previously owned clean vehicle credit for vehicles placed in service Jan.1, 2024 or later."

IRS Guidance: The IRS previously issued **proposed regulations**, **Rev. Proc. 2023-33** and **FAQs** on Oct. 6, 2023, that provide details to sellers to register with the IRS to be eligible to receive the credit transfers from taxpayers, and details that to participate, a dealer must verify their identity using the IRS "identity verification system" and register through **IRS Energy Credits Online** tool.

ECO Benefits: The IRS is encouraging any dealer or seller to register using **Energy Credits Online** to share in its benefits. These benefits include:

- Advance payments to dealers will typically occur *within 72 hours* of an accepted clean vehicle credit transfer Time of Sale report.

- The IRS acknowledges receipt and confirmation in real time that a qualified manufacturer has provided the VIN being sold as eligible when a Time of Sale report is submitted.

- Users can make corrections to information submitted through the tool.

- The tool keeps issuer information from year to year.

Dealer Registration: Enrollment in the **IRS Energy Credit Online** tool is now open and the IRS is advising clean vehicle sellers that they should begin the online enrollment process immediately. Initially, only one individual representative of the dealer or seller who is currently authorized to legally bind the dealer or seller can complete the initial registration through **IRS Energy Credits Online**. But starting in December 2023, dealers and sellers will be able to authorize *more than one* employee to submit Time of Sale reports and advance payment requests.

> **Comment:** Dealers can lose their registered status if they fail to comply with the program's requirements.

Additional Information: There are a number of other sources should more detailed information be needed:

- **IRS Pub. 5867, Clean Vehicle Dealer and Seller Energy Credits Online Registration User Guide**

- **IRS Pub. 5863, A Step-By-Step Guide for New and Used Clean Vehicle Dealers and Sellers for the Energy Credits Online**

- **IRS Pub. 5864, New and Previously Owned Clean Vehicle Credit Time of Sale Reporting with Energy Credits Online**

- **IRS Pub. 5865, Clean Vehicle Credit Transfer**

- **IRS Pub. 5866, New Clean Vehicle Tax Credit Checklist**

- **IRS Pub. 5866-A, Used Vehicle Tax Credit Checklist**

- **Dealer Registration Frequently Asked Questions**

- **Video: How Dealers and Sellers Register for Energy Credits Online**

- **Fact Sheet 2023-22, Frequently Asked Questions About the New, Previously Owned and Qualified Commercial Clean Vehicles Credit (Code §30D(g) & 25E(f); Tax Credits)**

☞IRS Guidance on Writing Off Software Development Costs (Notice 2023-63)

The IRS has once again confirmed that software development costs are to be treated the same as any other "research and experimentation expenses." As a result, these costs are to be amortized over a 60-month period, beginning with the month that the software is first placed in service. If "overseas research" is involved, then the amortization period is extended out to 180 months.

> **Comment:** Compare this to **Reg. §1.167(a)-14** which provides for a 36-month write-off for website development costs. This is a more conservative approach regarding the capitalization the costs of internally developed software. Arguably, if your website is primarily for advertising, you could currently deduct such costs as "ordinary and necessary business expenses."

This new guidance, however, has expanded the definition of "software development." These activities now include planning and designing computer software, building a model, writing source code and converting it to machine-readable code, plus testing and making modifications to address defects.

> **Comment:** One significant activity that is *not* included in the definition of "software development" is maintenance that "does *not* result in up-grades or enhancements of the software." Instead, these are simply "period costs" that are currently deductible as "ordinary and necessary trade or business expenses" under **Code §162**.

☞IRS Delays Revised Form 1099-K Reporting Requirement Until 2024 (Notice 2023-74)

Following intense feedback from taxpayers, tax professionals and payment processors and to reduce taxpayer confusion, the IRS has released **Notice 2023-74** announcing a delay of the new $600 **Form 1099-K** reporting threshold for third-party settlement organizations for calendar year 2023. As the IRS continues to work to implement the new law, the agency will treat 2023 "as an additional transition year." According to the IRS, "this will reduce the potential confusion caused by the distribution of an estimated 44 million Forms 1099-K sent to many taxpayers who wouldn't expect one and may not have a tax obligation." As a result, reporting will *not* be required unless the taxpayer receives over $20,000 and has more than 200 transactions in 2023.

> **Comment:** The IRS had already delay the start of this new $600 threshold for the 2022 tax year. And it expected to receive 14 million more **Form 1099-K** information returns for the 2023 tax year (i.e., going from an estimated 30 million to 44 million) under this new lower threshold.

"Given the complexity of the new provision, the large number of individual taxpayers affected and the need for stakeholders to have certainty with enough lead time," the IRS is planning for a threshold of $5,000 for tax year 2024 "as part of a phase-in" to implement the $600 reporting threshold enacted under the **American Rescue Plan (ARP)**.

Following feedback from the tax community, the IRS is also looking to make updates to the **Form 1040** and related schedules for 2024 that would make the reporting process easier for taxpayers. Changes to the **Form 1040** series "are complex and take time." Delaying changes to tax year 2024 will allow the IRS "for additional feedback."

"We spent many months gathering feedback from third-party groups and others, and it became increasingly clear we need additional time to effectively implement the new reporting requirements," said IRS Commissioner Danny Werfel. "Taking this phased-in approach is the right thing to do for the purposes of tax administration, and it prevents unnecessary confusion as we continue to look at changes to the **Form 1040**. It's clear that an additional delay for tax year 2023 will avoid problems for taxpayers, tax professionals and others in this area."

The **ARP** required third-party settlement organizations (TPSOs), which include popular payment apps and online marketplaces, to report payments of more than $600 for the sale of goods and services on a **Form 1099-K** starting in 2022. These forms would go to the IRS (i.e., creating a "paper trail") and to taxpayers and would help taxpayers fill out their tax returns. Before the **ARP**, the reporting requirement applied only to the sale of goods and services involving more than 200 transactions per year totaling over $20,000.

As the IRS has previously stated, these **Form 1099-K** reporting requirements do *not* apply to personal transactions such as birthday or holiday gifts, sharing the cost of a car ride or meal, or paying a family member or another for a household bill. As a result, these payments are *not* taxable and should not be reported on **Form 1099-K**. However, the casual sale of goods and services, including selling used personal items like clothing, furniture and other household items for a loss, could generate a **Form 1099-K** for many people (i.e., given that one of these third-party payment apps, as opposed to cash or a check, is used), even if the seller has no tax liability from those sales (and, maybe, a nondeductible personal loss).

This complexity in distinguishing between these types of transactions factored into the IRS decision to delay the reporting requirements an additional year and to plan for a threshold of $5,000 for 2024 "in order to phase in implementation." The IRS, however, is inviting feedback on the threshold of $5,000 for tax year 2024, as well as "other elements of the reporting requirement, including how best to focus reporting on taxable transactions."

"The IRS will use this additional time to continue carefully crafting a way forward to minimize burden," Werfel said. "We want to make this as easy as possible for taxpayers. We will work to make the new reporting requirements easier for them, and we'll work closely with third-party groups, tax professionals and others to find the smoothest path to ensure compliance with the law. This is consistent with our **Strategic Operating Plan**. The IRS is focused on meeting taxpayers where they are and helping them get it right the first time."

Expanded information reporting, which will occur as the result of the change in thresholds for **Form 1099-K**, is important because it increases tax compliance and can reduce burden on taxpayers seeking to follow the law. The IRS believes that expansion must be managed carefully to help ensure that **Forms 1099-K** are issued only to taxpayers who should receive them. In addition, it's important that taxpayers understand what to do as a result of this reporting, and that tax professionals and software providers have the information they need to assist taxpayers. **(Misc.; Form 1099-K)**

> **Comment:** **Fact Sheet 2023-27** contains more details about this announcement.

IRS Issues Proposed Regulations for Sale of Seized Property (REG-127391-16)

The IRS has issued proposed regulations to "modernize the rules" regarding the sale of a taxpayer's property that has been seized by the IRS. The current rules, under **Reg. 301.6335-1**, date back to 1954 and "do *not* accommodate technological advances such as the internet or electronic payment processing." Key changes include 1) online sales no longer requiring special orders; 2) more modern payment methods for buyers; 3) an end to the lottery system currently in place when there is a tie between bids; 4) a ban on revenue officers buying items they personally seize; and 5) permission to group real and personal property sales into one listing to maximize proceeds. According to the IRS, the proposed rules will benefit taxpayers by making the sales process "both more efficient and more likely to produce higher sales prices." **(Reg. §301.6335; Property Seizures)**

Difficulty of Recovering Legal Fees When Victorious Against IRS (*Champions Retreat Golf Founders*, TC Memo. 2023-134 (11/8/2023))

Recovering attorney fees after winning a case against the IRS in court is not an easy proposition. Victorious taxpayers are permitted to recover their legal costs if they "substantially prevail on the issues," unless the government shows that its litigation position was "substantially justified." In addition, they also must have "exhausted all administrative appeals" at the IRS level before filing suit. The maximum recoverable lawyer fees incurred in 2023 in tax cases are $230 an hour. But individuals with net worth of $2 million or more are prohibited from recovering their legal costs from IRS.

In this recent case, the IRS position was found to be "reasonable." An LLC was partially victorious in Tax Court on the issue of whether its donation of a conservation easement on property, including a golf course, should be allowed as a deduction. But according to the Tax Court, the Service's position on the easement issue, although *not* ultimately correct, "was reasonable and substantially justified." **(Code §7430; Legal Fees)**

FROM CONSULTING CALLS:

☞**Tax Planning - IRA to HSA Transfers**

General Rules: First of all, this *once-in-a-lifetime* transfer is subject to the annual caps for HSA contributions for the year of the transfer (e.g., for 2024, $4,150 or $8,300). The transfer, however, does *not* have to be in the tax year that the HSA was first established. But the transfer must be made *directly* from the IRA to the HSA (i.e., it cannot go through your personal checking account even if it ultimately ends up in the HSA). And the owner of the IRA transferring the money needs to be the *same* as that of the HSA. In other words, the funds cannot come out of an IRA owned by one spouse and then put into an HSA owned jointly by the married couple (or, by the other spouse individually).

If the monies are coming out of *pre-tax funds* held by the IRA, you will *not* receive a "second deduction" when they are later transferred to the HSA (i.e., no "double dipping"). On the other hand, if the funds are coming from the *after-tax basis* in your Roth IRA, it might make sense to just take a nontaxable distribution from your basis in the account and then use the cash to make an otherwise allowable contribution to your HSA. And, as shown in the illustration below, this can be done as many times as you want. If, instead, you decide to extract the "earnings portion" of the Roth IRA, this can only be done once under this general exception without penalty or taxes (i.e., even if you are *not* 59½ or older, or the Roth IRA has *not* been in existence for at least five years), and again, there would be no tax deduction (since tax-deferred earnings are being used).

HDHP Coverage: As is the case with any contribution to an HSA, you must be covered by a "high-deductible health plan" in the tax year that the transfer from the IRA is being made, as well as meeting all of the other eligibility requirements. Furthermore, you must remain covered by the HDHP for at least 12 months (i.e., not just the remainder of the tax year) after the point in time that the transfer is being made. If not, the IRA transfer becomes taxable (and, also possibly subject to the 10% early withdrawal penalty).

> **Comment:** Contributions to an HSA can be made as late as the unextended due date of the return for the tax year in question. But the 12-month IRA "post-transfer requirement" is independent of this flexibility accorded annual HSA contributions. However, this "testing period" is different from when you first become eligible for an HSA mid-year. You do *not* have to pro rate the normal annual contribution amount (i.e., the *full* HSA amount for that tax year can nevertheless be contributed). But, you still have to remain HSA eligible for the *entire* 12-month period of the subsequent tax year, if you want this initial HSA transfer to remain eligible.

Once-in-a-Lifetime Limit: You can only make the IRA to HSA transfer once. An exception would be if you had a self-only HSA and initially made this IRA transfer based on the appropriate annual limit (e.g., $4,150 for 2024). If you then got married before yearend, you could then make another transfer to meet the increased limit for a family HSA (e.g., $8,300 for 2024) as long as it was for the same tax year.

Comment: Each spouse would have their own HSA, but the "family limit" (i.e., $8,300 for 2024) can split between them as they see fit, as long as the total contributed to their HSAs does *not* exceed the overall family limit for the tax year in question.

Tax Planning Options: Every client situation is different, but the establishment of an HSA, especially for children of our clients who are just starting out (and, having to get their own health insurance as of the last day of the month in which they turn 26 years old) is important as they may be paying off student loan balances, while having policy deductibles in the thousands of dollars. Consider the planning situation below and how it gets modified as certain objectives are met.

Example: "Tax Planning with HSAs and Roth IRAs"
Consider Amanda who inherited a small sum when her grandparents passed away. She opened an taxable investment account for this inheritance with Charles Schwab. Then, she gradually transferred the respective annual limit amounts to both a Roth IRA and an HSA. After five or six years, the entire balance in the former taxable investment account had been transferred over to these two tax-deferred accounts.

Being 34 years old at this point in time, Amanda is not as concerned with her future retirement, but more so with year-to-year medical expenses as she plans to get married in 2024 and start a family. The HSA has a current balance of $31,000, while the Roth IRA balance is $62,000. More importantly, the Roth IRA has a pre-tax basis of $44,000. So, starting for the 2024 tax year (where she will now be married as of 12/31/2024), Amanda will now start taking the basis out of the Roth IRA and transferring it over to her HSA. The family HSA account limit for 2024 will be $8,300 (which they can split between their respective HSAs). This planning strategy is *not* subject to the "once-in-a-lifetime" limit since it is simply a contribution of cash into the HSA on an annual basis.

The funds in her Roth IRA which had been earning tax-deferred dollars, continue to do so except that these funds will now be tax-deferred in Amanda's HSA. Her family's health care costs are her main concern now, but she will also try to put away money into her Roth IRA throughout 2024, although she will probably *not* have sufficient room in her budget to make the maximum contribution limit of $7,000.

Comment: An HSA account is basically a "disguised IRA" to the extent that it continues to grow tax-deferred until age 65 and an individual qualifies for Medicare. Even then, though, the HSA funds can continue to be used tax-free for qualified medical expenses. But if these HSA funds are needed for everyday living expenses, they are treated no differently than monies being distributed out of an IRA (i.e., subject to income tax, but *not* any penalty). Moreover, the HSA account will *not* be subject to the RMD rules unlike either a qualified retirement plan or an IRA.

Comment: If a married individual should die with a balance in their HSA, these funds can now be used by the surviving spouse for their medical expenses. And, upon the death of the surviving spouse, any nonspousal beneficiary (e.g., son or daughter) is treated the same as inheriting a retirement account balance or IRA (though there is no "10-year clear out rule" with the inherited HSA being taxable upon receipt). In other words, there is no opportunity in the law at this point to "rollover" the HSA balance inherited into the beneficiary's HSA.

Comment: The counter argument is that a Roth IRA would continue to grow and provide tax-free money upon retirement not only to the individual, but also their heirs. In the example above, Amanda is still going to contribute as much as she can to her Roth IRA (i.e., to replace this $44,000 of pre-tax basis in the account that is gradually converted over to her HSA). But the higher priority at this point in her life is to set aside funds to cover out-of-pocket medical expenses given that their family health insurance policy has a high deductible of $3,000 per spouse annually (i.e., $6,000 total). **(Code §223; HSAs)**

☞Tax Planning - RMDs and QCDs

Starting in 2023, only those individuals 73 and older as of the end of the year need to be taking out required minimum distributions (RMDs). Nevertheless, "qualified charitable distributions" can be made earlier once the individual reaches age 70½, as long as certain requirements are satisfied.

Qualified Charitable Distributions: Pursuant to **Code §408(d)(8)(B)(ii)**, only individuals who are age 70½ or older can make QCDs.. Although the **SECURE Act 1.0** raised the age for starting required minimum distributions from 70½ to 72, **Code §401(a)(9)(C)(i)**, the age for making QCDs was left at 70½. IRS **Notice 2007-7, A-37** clarifies that the QCD donor can be *either* an IRA participant donating from his own IRA or a beneficiary donating from an inherited IRA (as long as that beneficiary has reached age 70½ as of the actual date that the transfer is made).

Comment: This is the only Code provision to make the age 70½ "birthday" itself a significant event. As a result, someone who reaches age 70½ on

December 30th could have a difficult time getting their IRA provider to make the QCD on the last day of the year. It would have been easier to allow QCDs to occur anytime during or after the calendar year the individual reaches age 70½, but that is *not* what the law says.

Comment: Most of the brokerage firms that act as IRA custodians also provide a checkbook for their clients' IRA accounts. Therefore, it is even easier to make a QCD by simply writing a check to the eligible charity. Normally, it is sufficient that the check be transferred to the charity (i.e., put in the mail or actually delivered), even it is *not* cashed until the subsequent tax year in order for the charitable deduction to be claimed (i.e., assuming that the individual itemizes their deductions on **Schedule A**). But, with QCDs the distribution must be made by the last day of the tax year (i.e., so that a **Form 1099-R** would be generated had the IRA custodian made the donation directly). To be safe, if a check was drawn on the IRA, it would be advisable that it be received by the charity in time for it to be deposited into their account by yearend.

QCDs Satisfy RMD Requirement: Besides avoiding an individual's AGI from increasing due to an RMD (i.e., since the QCD offsets this amount), it also helps to satisfy the annual RMD amount that must otherwise be made.

Comment: Essentially, the individual is accomplishing two things at once by making a charitable donation to the tax-exempt entity that the they otherwise want to help, while also meeting the RMD rule. And, even if the individual chooses to use the standard deduction (i.e., as opposed to itemizing their deductions on **Schedule A**), they will still benefit by this for-AGI deduction (especially where their AGI can affect a number of related items such as how much of their SSBs will be subject to tax).

Comment: Even if an older individual (e.g., age 73 or older) is still working and therefore is potentially eligible to make a deductible IRA contribution, this amount is *not* allowed to serve as an offset to an otherwise required minimum distribution. Instead, they are treated as two entirely separate transactions. Contributions and distributions are reported as such each year to the Service by the financial institution or other IRA custodian.

QCDs Must Be Made Out of IRA: Perhaps it is because retirement plan administrators do not want to get caught up in making these distributions on behalf on their plan participants, but QCDs have to originate from an IRA. Nevertheless, as long as the funds are first transferred from the plan (i.e., 401(k) or 403(b) plan) to the individual's IRA, the QCD can then be carried out. But, if the individual also needs to make a RMD out of their plan, it must be done first. Then, if they want to do a QCD with funds received from the retirement plan, the necessary amount can be subsequently transferred over to their IRA to do so.

Comment: Even though an individual has reached their "required beginning date" (RBD) for needing to take out RMDs each year, this rule is suspended if they are still working for the employer sponsoring the plan (and, there is no mention of having to work a certain minimum amount of hours each week). The other catch is that the individual cannot otherwise own (directly or indirectly) *more than 5%* of the company that they work for if they want to qualify for this exception.

Comment: Nothing mentioned here affects the rule that RMDs can be taken out of any IRA that the individual owns, while RMDs from a qualified retirement plan must actually be taken from each and every plan account that they still have as of their RBD. That is why the RMD must be made *before* any transfer of funds needed for a QCD are transferred to an individual's IRA.

Comment: Qualified charitable distributions can be made directly to the eligible charity from a traditional IRA, inherited IRA, inactive Simplified Employee Pension (SEP) plan and inactive Savings Incentive Match Plan for Employees (SIMPLE) IRAs. This is because "inactive" SEP and SIMPLE IRAs are accounts that no longer receive employer contributions.

Eligible Charities: Qualified charitable distributions can be made only to certain qualified charitable organizations. Currently, QCDs cannot be made to donor-advised fund sponsors, private foundations and supporting organizations, though these are otherwise categorized as charities.

Tax limitations of QCDs: A donor can make a qualified charitable distribution that exceeds the individual's required minimum distribution for a given year. That extra distribution, however, cannot be carried over (i.e., used to meet the minimum distribution requirement for future years). This contrasts with other strategies, such as a donation of cash and appreciated securities, where a large donation can be made in one year and the tax benefits can be carried forward (i.e., if there is an excess over the 30% or 60% of AGI limits). It also differs from contributions to a donor-advised fund or foundation, which can also allow you to front-load giving in a high-income year and use those funds support charities in the future.

Comment: State tax rules on QCDs vary, so donors making qualified charitable distributions should consult a tax advisor to understand the impact on state tax liabilities.

Comment: Although qualified charitable distributions can be a good option in the right circumstances, they may *not* be the best charitable giving strategy for everyone. For example, if you have securities that have grown in value since you bought them, it may make more sense and provide greater tax benefit to donate them to charity instead of making a QCD (i.e., by selling them first and then donating the after-tax proceeds).

QCDs and 60% AGI Limit on Cash Donations: Because QCDs reduce the balance of the IRA, they may reduce required minimum distributions in future years. QCDs are also *not* counted toward the maximum amounts deductible for those who itemize their giving on their taxes (i.e., the $100,000 QCD can be above and beyond those limits). For these reasons, a QCD can potentially enable a donor to give a bigger charitable gift than they could if they just donated cash or other assets.

Comment: The QCD cap is $100,000 (per spouse, if otherwise married) for the 2023 tax year. Due to inflation, this amount increases to $105,000 for 2024.

Comment: The $100,000 per person limit (i.e., for 2023) applies to the sum of all QCDs taken from all IRAs in a year. A donor can make one large contribution or several smaller contributions over the course of the calendar year. Remember that QCDs can be made from any or more than one of the IRA types (i.e., traditional, inherited, inactive SEP and inactive SIMPLE IRAs) noted above.

Form 1040 Reporting Requirements: In early 2024, the IRA owner will receive **Form 1099-R** from their IRA trustee that shows any IRA distributions made during calendar year 2023, including *both* regular distributions and QCDs. The total distribution is shown in **Box 1** on that form. There is no special code for a QCD. Like other IRA distributions, QCDs are reported on **Line 4** of **Form 1040**. If part or all of an IRA distribution is a QCD, enter the total amount of the IRA distribution on **Line 4a**. This is the amount shown in **Box 1** on **Form 1099-R**. Then, if the full amount of the distribution is a QCD, enter 0 on **Line 4b**. If only part of it is a QCD, the remaining taxable portion is normally entered on **Line 4b**. Either way, be sure to enter "QCD" next to **Line 4b**. Additional details are included in the instructions to the 2023 Form 1040.

Contemporaneous Written Acknowledgment: As mentioned above, QCDs are *not* deductible as charitable contributions on **Schedule A**. But, as with deductible contributions, the donor must still get a "contemporaneous written acknowledgment" (i.e., CWA) of their contribution from the charitable organization *before* filing their return. In general, the acknowledgment must state the date and amount of the contribution and indicate whether the donor received anything of value in return. **(Code §170; QCDs)**

☞Tax Planning - Sec. 754 Elections to Step-up Inside Bases of Partnership Assets

"Sec. 754 elections" are an excellent way to equalize a partner's "outside basis" with their share of "inside bases" of the various assets held on the partnership's balance sheet. This summary is an overview of the IRC sections involved with making a valid Sec. 754 election, along with several illustrations of how this would work with: (1) an LLC holding a building for rental purposes which had appreciated significantly before a new partner, for instance, was to buy into the entity; or (2) a trade or business holding a variety of assets with goodwill, most likely, being the asset with the greatest appreciation to-date.

Applicable IRC Sections: **Code §743(b)** is the section that would come into play if any one of the following scenarios were to occur: (1) An LLC is owned equally by A, B and C and C decides to sell their one-third interest to an unrelated third-party D; (2) Same scenario, but C instead died and their daughter D inherited her mother's LLC interest; or (3) One of the current LLC members A decides to buy out B and C thereby resulting in a SMLLC.

On the other hand, suppose the LLC decided to refinance its asset (e.g., building) and use the funds to make a liquidating distribution in order to extinguish C's interest in the LLC. In this case another Code section (i.e., **Code §734(b)**) comes into play which creates the opportunity to make a Sec. 754 election due the potential gain realized and recognized by he exiting partner upon the termination of their interest.

Comment: Another scenario might arise where the exiting partner were to received some of the assets that the partnership owned (instead of cash) to liquidate their interest in the entity. A problem arises, however, when the exiting partner does *not* have sufficient "outside" basis to carryover and take the "inside" basis that the partnership had in this distributed asset. Instead, the exiting partner has to "substitute" their remaining "outside" basis and assign it to the asset(s) received. But this can result in "disappearing basis." The partners who still own the partnership can elect, however, to use this "disappearing basis" amount to step up the "inside" bases of the assets that remain on the balance sheet of the entity.

Mechanics of Sec. 754 Election: Once a valid Sec. 754 election is made and is included with the return for the tax year in question, the regulations under **Reg. §1.755-1** take over and spell out the mechanics of how the step-up will be applied to the "inside" bases of the various assets held by the partnership. The key principle to keep in mind, however, is that Sec. 754 step-up amount *can never be used so as to increase the gap* that already exists between the asset's current adjusted basis and its FMV. Instead, the entire purpose of this allocation is to *close that gap*, at least as it applies to the allocable share of assets belonging to the new partner entitled to this step-up amount.

Comment: If a Sec. 754 election is already in effect (i.e., one was made in a prior tax year), it does *not* need to be made again. Also, the normal deadline for making a Sec. 754 election is the extended due date for the partnership's tax return (i.e., Sept. 15th for a calendar yearend entity). If this deadline is missed, "procedural regulation" **Reg. §301.9100-2** grants an *automatic* 12-month extension (i.e., for a 2023 **Form 1065** it would increase the deadline from the normal extended due date of 9/15/2024 to 9/15/25).

Comment: The **2004 Tax Act**, effective for tax years beginning on or after 1/1/12005, mandates that a "deemed Sec. 754 election" will *automatically* be in effect for a "step-down" regarding the inside bases of the entity's assets where the total "gap" between the assets' adjusted bases are more than $250,000 above the aggregate sum of those assets' FMV.

Example: "LLC Holding Appreciated Real Estate - Sale of LLC Member's Interest"
Assume that an LLC owned equally by A, B and C purchased a building for $600,000. A number of years later when the building's adjusted basis was $300,000 and the mortgage was paid off, the building had a FMV of $900,000, C decides to sell their one-third interest to D (and unrelated third-party) for $300,000. Assuming a balance sheet where the building, along with a few funds in the LLC's checking account, were the only assets, what would be C's realized and recognized gain?

C's inside basis of the building would initially be 1/3 x $300,000 = $100,000. Given that their interest sold for $300,000 (i.e., 1/3 x $900,000 FMV), the realized and recognized gain would be $200,000. The first $100,000 of this gain would be due to the S/L depreciation claimed over the life of the building to-date and would be characterized as "unrecaptured Sec. 1250 gain" which is taxed as no more than a 25% marginal tax rate. The remainder of the $200,000 gain, namely $100,000 due to the underlying appreciation of the building, would be "Sec. 1231 gain." Both types of gain would be shown on **Form 4797** with the total $200,000 gain flowing to the **Form 8949** worksheet for **Schedule D** where is would be netted against any capital losses (or, added to other capital gains) with the final net capital gain or loss flowing over to **Schedule D**.

Without a Sec. 754 election, D would take an "outside" basis equal to the cost that they paid, or $300,000. Yet, their "inside" basis would only be the same as what C had, or $100,000. The bottom line is that D would lose out on ordinary deductions of this missed depreciation (with marginal tax rates up to 37%) while having a higher gain (i.e., since they would be stuck with just a $100,000 inside basis instead of the stepped-up $300,000 basis with the highest marginal tax rates being 25% and 20%, respectively) if and when the building was sold. To make matters worst, D could ultimately incur a capital loss if the LLC was then to dissolve passing out D's one-third share of the building's sale's price of $900,000, or $300,000 in a subsequent tax year (e.g., the building was sold in late 2023, but the LLC was *not* dissolved until early 2024).

Comment: If the sale of the building and the dissolution of the LLC were to occur in the *same* tax year, then the higher capital gain (i.e., due to the lack of the stepped-up basis to D) would be *offset* by the capital loss that D would also have on the termination of their interest in the partnership. In situations such as this, the "automatic 12-month extension" under **Reg. §301.9100-2** might be used to make a late Sec. 754 election (if that was in fact possible given it had *not* been more than 12 months after the extended due date for filing the partnership return).

Under **Code §743(b)**, if the entity did *not* already have a Sec. 754 election in place, it would be entitled to do so. But D, with only a one-third interest, would *not* be in a position to demand that this happen. So, it would be in D's best interest to have in writing that the election would be made. And, it should not really matter to either A or B since neither their inside or outside bases would be affected.

In this rather straightforward set of facts, **Reg. §1.755** would assign the entire $200,000 step-up in basis (i.e., $300,000 "outside" basis v. $100,000 "inside" basis) solely to the basis of the building. This would be reflected on **Form 4562** where the original basis of the building $600,000 would be listed with $300,000 of accumulated depreciation being taken thus far resulting in an adjusted basis of $300,000. And, this depreciation would flow to the LLC's rental schedule on **Form 8825**, with D being allocated one-third of the amount (the depreciation would be listed along with any other rental expenses resulting in the overall rental income or loss ultimately flowing to **Box 2** of D's K-1).

Given a valid Sec. 754 election is in effect, the $200,000 step-up amount would also be shown on **Form 4562** as a *separate* line item (i.e., just like an entirely new depreciable asset had just been purchased). And, an appropriate label would be "Sec. 754 step-up" with the "date placed in service" being the day that D came into ownership of their one-third interest in the LLC. And, if for example, the original depreciation MACRS classlife and method had be 19 years, S/L (i.e., for a commercial building), this would also be how this $200,000 should be treated as well.

The depreciation resulting from the $200,000 step-up would be *solely* allocated to D (i.e., none would flow to either A or B), and it should be shown as "additional information" on D's K-1. To illustrate, suppose this additional depreciation for the tax year that D had joined the LLC amounted to $2,500 and D's share of net rental income shown in **Box 2** of their K-1 was $12,500. The net effect would be that D would pick up just $10,000 (i.e., $12,500 - 2,500) of rental income on **Schedule E** of his personal tax return.

Example: "LLC Holding Appreciated Real Estate - Inheritance of LLC Member's Interest"
Same facts as above, but instead C died and D her daughter inherited her mother's one-third interest in the LLC. Given that the FMV as of the date of C's death was $900,000 and that their was no mortgage on the property, D would take an initial "outside" basis of $300,000 (i.e., the FMV as of the date of C's death). Meanwhile, as with the Example above, her share of the LLC's "inside" basis in the building would just be $100,000.

Again, given that a valid Sec. 754 election was in effect, the daughter would have the same share of depreciation due to the $200,000 step-up *solely* allocated to her as shown on her K-1. The only difference from a tax standpoint in these two examples is that there was no "sale" in this one-third LLC interest passing from C to D. Therefore, no gain would have been realized or recognized to C on her final tax return.

Example: "One Member Buying Out Other Owners Resulting in SMLLC"
Using the example above with the LLC owning an appreciated building with a current FMV of $900,000 and no mortgage, assume that the one member A decides to pay $300,000 each to B and C to buy out their interests in the LLC. The result is that this multi-member LLC which was previously taxed as a partnership would now be treated as a SMLLC (which ultimately is a **Schedule E** rental property on A's personal return).

Rev. Rul. 99-6 specifically addresses this situation and offers some insight as to how A's purchase of B's and C's LLC interest can result in a stepped-up basis to the building that A now owns solely in their name. But since this LLC is no longer treated as a partnership for tax purposes, you do *not* technically say that this is a "Sec. 754 election."

When A buys out B and C LLC interests, the former partnership is instantly dissolved with the asset(s) (i.e., here, the building) being deemed distributed to A, B and C as tenants-in-common. B and C are then treated as selling their respective ownership interests in the building to A (and, the gain to each of them would be $200,000 based on their "substituted" basis of $100,000 against the $300,000 sales proceeds that each of them received from A). $100,000 of the gain to each of them would be "unrecaptured Sec. 1250 gain" taxed at no more than a marginal tax rate of 25%, with the remaining $100,000 gain being treated as "Sec. 1231 gain." As was discussed above, the total $200,000 gain to B and C each would be initially reported on **Form 4797** and then would flow to **Form 8949** and **Schedule D**.

The purchase would be shown on **Form 4562** with the historical adjusted basis of $100,000 with the same MACRS classlife and S/L method being carried over to A's personal return (i.e., "shoes depreciation"). The step-up, though, for the $600,000 paid for the other two-thirds cost of the building would be reflected as a "new" asset on a separate line of the **Form 4562**. It would list the "date placed in service" as the day on which this sale of B and C interests were purchased and an original "cost" of $600,000. There would be a "fresh start" for depreciation purposes and given this was a commercial building, it would be a MACRS 39-year asset using the S/L method.

Example: "Termination of LLC Member's Interest with Liquidating Distribution"
Using the same facts as above, assume that A and B cause the LLC to refinance the building and it now borrows $300,000 (i.e., 1/3 x current FMV of $900,000) to make a liquidating distribution to C in termination of their partnership interest. Since there are no "hot assets" (i.e., partnership assets whose disposition would result in other than capital gain or

Sec. 1231 gain, but instead ordinary income), **Code §741** (i.e., instead of **Code §751**) would control and grant capital asset treatment to C upon the relinquishment of their interest.

C's gain of $200,000 (i.e., their "outside" basis of $100,000 in their interest against the $300,000 liquidating distribution) would be treated differently than the scenarios discussed above. Instead of the gain being split between $100,000 of "unrecaptured Sec. 1250 gain" (i.e., due to C's share of the S/L depreciation taken to-date on the building by the LLC), C's *entire* $200,000 gain would be treated solely as a "Sec. 1231 gain" which would subject to no more than a 20% marginal tax rate. It would also be reflected on C's **Form 4797** as such and would then flow to **Form 8949** and **Schedule D**.

Comment: Because of how the regulations were written pursuant to **Code §741**, the potential for any "unrecaptured Sec. 1250 gain" due to the S/L depreciation taken on the building by the LLC would now remain with the entity and would therefore be the responsibility of the remaining members A and B if and when the building is ultimately sold.

Example: "Sec. 754 Step-up - Sale of Partnership Interest with T/B Assets"
Instead of the LLC holding appreciated real estate as in the illustrations above, assume that the LLC conducts a business with a variety of assets on its balance sheet. Furthermore, if these assets had an aggregate FMV of $900,000, with the following adjusted bases listed below, how would the sale of C's one-third interest in the LLC for $300,000 be treated?

Reg. §1.755-1 requires that the balance sheet be "split" between assets with *ordinary* income potential if sold as opposed to other *capital or Sec. 1231* assets. Assume that the LLC has ordinary income assets consisting of F&F, computers, equipment and A/Rec which currently have a remaining adjusted bases of $300,000 (and, C's share of this "inside" basis is $100,000).

As far as the other side of this "split," the LLC has goodwill which has never been amortized (i.e., it is self-created over the life of the existing business and no goodwill has ever been acquired through an outside business acquisition). Therefore, if the business was ever sold, **Code §1245** would *not* come into play as far as the recapture of any prior deductions for amortization.

Putting some numbers to this illustration, assume that the "ordinary income" assets have a current FMV of $450,000, while the "capital/Sec. 1231" asset likewise has a value of $450,000 (i.e., with no liabilities currently on its books; this is why the LLC is valued at $900,000).

C's gain when they sell their LLC interest to an unrelated outside third-part D is again $200,000 (i.e., their "outside" basis in their LLC interest of $100,000 with $300,000 of sale proceeds being received from D; $150,000 of proceeds allocated to the "ordinary income" assets while the remaining $150,000 of the proceeds is allocated to C's share of the LLC's goodwill). The character of the gain would be split between ordinary income assets (one-third of which are deemed to be indirectly owned by C). Since these assets have an aggregate "inside" adjusted bases of $300,000, C's share of this amount is again $100,000. As a result, the $150,000 of sales proceeds allocable to the "ordinary income" assets is offset by C's $100,000 "outside" basis producing a gain of $50,000 to be taxed at ordinary income rates.

C's remaining gain allocable to the sale of his indirect ownership of one-third of the LLC's goodwill would be $150,000 (i.e., $150,000 sales proceeds less a zero "inside" basis in the LLC's goodwill) and this would be accorded capital gains rates.

Now, given that the new LLC member D has paid $300,000 to acquire C's interest, but their share of "inside" bases is only $100,000, you have the same need to have a Sec. 754 election be made by the entity to equalize this situation. Here, though, you have two separate and distinct groups for assets entitled to this $200,000 step-up. The allocation of this step-up is based on the "ordinary income" assets have a "gap" between an aggregate FMV of $450,000 and current aggregate adjusted bases of $300,000. Thus, there is a $150,000 overall "gap" for these assets. On the other hand, the "capital/Sec. 1231" assets have a gap of $450,000 (i.e., FMV of $450,000 and an adjusted basis of zero). As a result, the $200,000 "step-up" pursuant to the Sec. 754 election should be split 25% to the "ordinary income" assets (i.e., $50,000) and 75% to the "capital/Sec. 1231" asset (i.e., $150,000 for the goodwill).

Given that the $200,000 step-up will be split 25/75, the final requirement is to determine how much of a "gap" exists for each asset within its respective group. For instance, suppose there are $50,000 of uncollected A/Rec that have a zero basis under the cash method of accounting. Meanwhile, the other "ordinary income" assets have a $100,000 "gap" between their FMV and adjusted bases (i.e., $400,000 of the $450,000 total FMV of this group of assets compared to their aggregate adjusted bases of $300,000)). Then, one-third of the $50,000 "step-up" would be allocated to the A/Rec (i.e., $16,667), while two-thirds (i.e., $33,334) would be allocated to the F&F, computers and equipment.

As far as the other $150,000 of the "step-up," all of this would be allocated to the one "capital/Sec. 1231" asset which is the goodwill. Therefore, the "inside" basis allocable to new member D would now be $150,000 (i.e., instead of zero). And if the business was sold and $450,000 was received for the goodwill, D would *not* have any gain on his $150,000 (i.e., one-third) share of the proceeds.

The key point to understand and appreciate here is that only D gets the benefit of the "step-up" amount of $200,000. A and B are *not* affected at all by this "step-up." So, for instance, when the $50,000 of A/Rec are collected by the LLC, D's "inside" basis would be $16,667 which would completely offset their share of income upon their collection.

Likewise, the other "ordinary income" assets (i.e., F&F, computers, equipment) would receive a allocated step-up of $33,334. In addition, since this step-up is pursuant to **Code §743(b)** as opposed to **Code §734(b)**, this would create "new" bases in these assets which would be eligible for either bonus depreciation or Sec. 179 immediate expensing. And, these "stepped-up" bases would be shown as "newly-acquired assets" on **Form 4562** with the label "Sec. 754 step-up" for each type of asset.

The same is true of the $150,000 step-up for the goodwill. As an amortizable asset, **Code §197** would allow for a 180-month write-off starting in the month that the step-up was effective. **(Code §754; Sec. 754 Election)**

Comment: There is no question that a Sec. 754 step-up regarding a new partner's share of the entity's "inside" basis so as to equalize it with the "outside" basis that they would have in their partnership interest can be complex. But, keep in mind that one of the main objectives is to keep the new partner (i.e., here, D) from having to recognize gain (or, income upon collection of the A/Rec) that C (i.e., the selling) has already taken into account on the deemed sale of their indirect ownership of each and every one of these partnership assets.

Comment: A really critical principle which should be stressed when teaching the mechanics of the Sec. 754 election process to newer tax staff is that "you can't get a different answer than what you would have had if C (i.e., the selling LLC member here) instead owned their one-third of the LLC's assets directly in a **Schedule C** or **F** proprietorship and then sold these assets themselves."

Comment: When it is D (i.e., the daughter) inheriting her interest upon her mother's (i.e., C) death, it is even more advantageous since regardless of any estate tax being due, there was no "sale or exchange" in order for this beneficiary D to received a step-up to FMV of the inherited partnership interest.

☞Moving Existing Building Needs to Be Capitalized as "Land Preparation Cost"

A client literally moved a storage building at their place of business. Picked up with a crane, rollers, etc. The move was probably all of 300 yards to a different section of the land on the same parcel. It was done to facilitate the construction of an additional building to be used by this S corporation tenant that is currently leasing the land and building for their business. The "move" cost $133,515.

Even though the move did *not* enhance the value of the current structure nor increase its useful life, it was still necessary for the preparation of the site for the construction of the new building. As a result, the IRS would have a good argument that such a cost needs to be added to the land (i.e., and *not* to the basis of the newly-constructed building).

Comment: How is cost of moving the existing building off the site intended for the new building's construction any different than preparing the land by clearing out any other obstacle that could prevent the start of construction on the new building? And, as far as where the moved building is to be located, there might well be some costs to prepared that land for receiving this structure (i.e., which would also require capitalization as a nondepreciable "land cost").

Comment: One could also argue that under **Code §162** despite being a "necessary cost," it was *not* one that would be "ordinarily" incurred in the normal course of the S corporation's trade or business. Thus, the need to capitalized this cost as a "land preparation cost." And, given its materiality, the Tax Court would most likely uphold an IRS position that it be capitalized.

Another issue is that the building is owned and reported as a rental property on the client's **Schedule E** (i.e., it is a "self-rental" situation). There is a valid lease in place between the clients individually and their S corporation that rents the structure from them. The payments for the "move" were made by the S corporation. Is this permissible or should the payments have been made individually by the client? **(Code §168; Land Preparation Costs)**

> **Comment:** Whether the cost to move the building are paid by the **Schedule E** landlord or the S corporation tenant, it needs to be capitalized. It is *not* in the nature of a "leasehold improvement" such a "qualified improvement property" (QIP) which can treated as MACRS 15-year asset otherwise eligible for bonus depreciation. Nor, is the cost allocable to the new building's structure as it was incurred to prepare the land for the new construction. Moreover, it was necessitated by the business needs of the S corporation tenant in this instance. Thus, it is reasonable that the S corporation incurred the cost.

☞Potential Issues with New Beneficial Ownership Information Rules

The **Corporate Transparency Act (CTA)** was passed in 2021 and represented an attempt to expose the owners of entities that could potentially be involved in money laundering and other illegal activities. **Financial Crimes Enforcement Network (i.e., FinCEN)** was authorized to enforce its provisions. Despite being effective for new entities within 90 days of formation (Note: It was to be 30 days but was extended) starting in 2024 (Note: Older entities have until 1/1/2025 to submit their reports), necessary forms have *not* yet be released. There are also a number of unanswered issues that need to be addressed. Furthermore, a great deal of personal information will be collected but there is a concern over how this unprecedented treasure trove of nationwide data will be protected from potential hackers. Nevertheless, failure to file these BOI reports can result in a $500/day penalty, along with being treated as a felony punishable by a 2-year prison term. Yet, unsophisticated small business owners might not even be aware of this new reporting requirement (which must be done electronically). And, if there is "any information that has changed," a new updated report must be submitted within 30 days. **(Misc.; BOI Reporting)**

> **Comment:** Another potential issue concerns SMLLCs. For instance, suppose an individuals owns multiple **Schedule E** rental properties. And, for limited liability purposes, they form separate LLCs to hold title for each one. Technically, a separate BOI report would have to be filed for each SMLLC (with penalty exposure for failure to do so).

> **Comment:** There is an filing exemption for those entities with 20 or more employees (or, $\geq$ $5 million of gross receipts), but that would *not* cover small business owners with fewer employees, or that rental property owner.

> **Comment:** The **Financial Crimes Enforcement Network (FinCEN)** has updated its frequently asked questions on the beneficial ownership information (BOI) reporting requirements that will take effect on 1/1/24. The updated FAQs include new questions and clarification about reporting companies, beneficial owners, company applicants, reporting requirements, initial reports, and reporting company exemptions. The updated FAQs can be accessed on the FinCEN **website**. And FinCEN expects to publish further guidance in the future.

☞Don't Overlook Availability of WOTC When Hiring New Employees

This tax credit is for employers who hire "economically challenged employees." The work opportunity tax credit is for businesses that hire ex-felons, qualified veterans, residents of empowerment zones or rural renewal counties, and certain other workers who face barriers to employment. The credit is limited to 40% of the first $6,000 in wages paid to each worker in the *first* year of employment, resulting in a $2,400 credit per qualifying worker. The credit for hiring some veterans is even higher. Employers must pre-screen job applicants using **Form 8850**, which the applicant and the employer fill out. The employer then submits the form to the state workforce agency, generally within 28 days of the employee starting work, to certify the hiring is credit-eligible. Employers use **Form 5884** to calculate the exact amount of the credit. **(Code §51; WOTC)**

Yours very truly,

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