2024 Federal Tax Update

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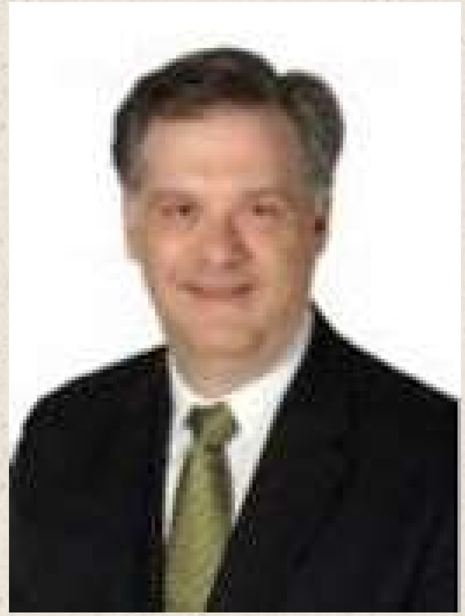

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SECTION I:

TAX RATES, REPORTING AND FILING STATUS

I. Tax Rates

Married Individuals Filing Joint Returns and Surviving Spouses

Taxable Income	Tax Liability
Not over $23,200.	10% of taxable income.
Over $23,200 but not over $94,300.	$2,320 plus 12% of the excess over $23,200
Over $94,300 but not over $201,050.	$10,852 plus 22% of the excess over $94,300
Over $201,050 but not over $383,900.	$34,337 plus 24% of the excess over $201,050
Over $383.900 but not over $487,450.	$78,221 plus 32% of the excess over $383,900
Over $487,450 but not over $731,200.	$111,357 plus 35% of the excess over $487,450
Over $731,200.	$196,669.50 plus 37% of the excess over $731,200

Heads of Households

Taxable Income	Tax Liability
Not over $16,550.	10% of taxable income.
Over $16,550 but not over $63,100.	$1,655 plus 12% of the excess over $16550.
Over $63,100 but not over $100,500.	$7,421 plus 22% of the excess over $63,100.
Over $100,500 but not over $191,950.	$15,469, plus 24% of the excess over $100,950.
Over $191,950 but not over $243,700.	$37,417 plus 32% of the excess over $191,950.
Over $243,700 but not over $609,350.	$53,977 plus 35% of the excess over $243,700.
Over $609,350	$181,954.50,plus 37% of the excess over $609,350.

Unmarried Individuals (other than Surviving Spouses and Heads of Households)

Taxable Income	Tax Liability
Not over $11,600.	10% of taxable income.
Over $11,600 but not over $47,150.	$,1,160 plus 12% of the excess over $11,600.
Over $47,150 but not over $100,525.	$5,426,plus 22% of the excess over $47,150.
Over $100,525 but not over $191,950.	$17,168 plus 24% of the excess over $100,525.
Over $191,950 but not over $243,725.	$39,110.50 plus 32% of the excess over $191,950.
Over $243,725 but not over $609,350.	$55,678.50 plus 35% of the excess over $243,725.
Over $609,350.	$183,647.25 plus 37% of the excess over $609,350.

Married Filing Separately

Taxable Income	Tax Liability
Not over $11,600.	10% of taxable income.
Over $11,600 but not over $47,150.	$,1,160, plus 12% of the excess over $11,600.
Over $47,150 but not over $100,525.	$5,426,plus 22% of the excess over $47,150.
Over $100,525 but not over $191,950.	$17,168 plus 24% of the excess over $100,525.
Over $191,950 but not over $243,725.	$39,110.50 plus 32% of the excess over $191,950.
Over $243,725 but not over $365,600.	$55,678.50 plus 35% of the excess over $243,725.
Over $365,600.	$98,334.75 plus 37% of the excess over $365,600.

Estates and Trusts

Taxable Income	Tax Liability
Not over $3,100.	10% of taxable income.
Over $3,100 but not over $11,150.	$310, plus 24% of the excess over $3,100.
Over $11,150 but not over $15,200.	$2,242 plus 35% of the excess over $11,150.
Over $15,2000.	$3,659.50,plus 37% of the excess over $15,200

B. Tax Rates for 2025 (Rev. Proc. 2024 – 40; IR 2024 – 273)

Married Individuals Filing Joint Returns and Surviving Spouses

Taxable Income	Tax Liability
Not over $23,850.	10% of taxable income.
Over $23,850 but not over $96,950.	$2,385 plus 12% of the excess over $23,850.
Over $96,950 but not over $206,700.	$11,157 plus 22% of the excess over $96,950.
Over $206,700 but not over $394,600.	$35,302 plus 24% of the excess over $206,700.
Over $394.600 but not over $501,050.	$80,398 plus 32% of the excess over $394,600.
Over $501,050 but not over $751,600.	$111,462 plus 35% of the excess over $501,050.
Over $751,600.	$202,154.50 plus 37% of the excess over $751,600.

Heads of Households

Taxable Income	Tax Liability
Not over $17,000.	10% of taxable income.
Over $17,000 but not over $64,850.	$1,700 plus 12% of the excess over $17,000.
Over $4,850 but not over $103,350.	$7,442 plus 22% of the excess over $64,850.
Over $103,350 but not over $197,300.	$15,912 plus 24% of the excess over $103,350.
Over $197,300 but not over $250,500.	$38,460 plus 32% of the excess over $197,300.
Over $250,500 but not over $626,350.	$55,484 plus 35% of the excess over $250,500.
Over $662,350.	$187,031.50 plus 37% of the excess over $626,350.

Married Filing Separately

Taxable Income	Tax Liability
Not over $11,925.	10% of taxable income.
Over $11,925 but not over $48,475.	$1,192.50 plus 12% of the excess over $11,925.
Over $48,475 but not over $103,350.	$5,578.50 plus 22% of the excess over $48,475.
Over $103,350 but not over $197,300.	$17,651 plus 24% of the excess over $103,350.
Over $197,300 but not over $250,525.	$40,199 plus 32% of the excess over $197,300.
Over $250,525 but not over $375,800	$57,231 plus 35% of the excess over $250,525.
Over $375,800.	$101,077.25 plus 37% of the excess over $335,800.

Estates and Trusts

Taxable Income	Tax Liability
Not over $3150.	10% of taxable income.
Over $3,150 but not over $11,450.	$315 plus 24% of the excess over $3,150.
Over $11,450 but not over $15,650.	$2,307, plus 35% of the excess over $11,450
Over $15,650.	$3,777, plus 37% of the excess over $15,650.

II. Filing Status Issues

A. Married Filing Joint Status

- **1. Married Filing Joint Status Applies to Nonresident Alien Spouse. – Section 7703**

- a. The determination of whether an individual is married shall be made at the close of the taxable year. The exception would be if the spouse died during the taxable year. In that event such determination shall be made at the date of death and an individual legally separate from their spouse under a decree of divorce or separate maintenance shall not be considered married

A. Married Filing Joint Status

- b. Married Individuals Living Apart. If an individual who is married and who files a separate return maintains as his or her home a household which constitutes for more than one half of the taxable year the principal place of abode of a child (qualifying child) and such individual furnishes over half the cost of maintaining the household during the taxable year and during the last six months of said year the other spouse is not a member of the household such shall be considered on married.

A. Married Filing Joint Status

- c. Section 7703 applies also to nonresident aliens

Example

- **Elbasha v. Comm., TC Memo 2022 – 1**. Married couple with wife living abroad and who is a nonresident alien does not entitle taxpayer to claim single filing status. The determination of whether an individual is married is made at the close of the tax year unless the spouse died during the year. A person is considered not married at the close the taxable year if they either are separated under a decree of divorce or separate maintenance agreement or furnishes over half of the cost of maintaining a household that does not include the spouse but does include a qualifying child.

A. Married Filing Joint Status

- **2. Tax Return is Jointly Filed Despite Spouse Not Signing Return**

Example

- **Soni v. Comm., CA – 2; No. 22 – 829 – AG (7/27/24).** The 2nd Circuit Court of Appeals affirmed the Tax Court’s decision that the taxpayers tax return was jointly filed despite the fact one of the spouses did not sign the return. Of importance is that the spouse knew her return had to be filed, the spouse was an experienced business person, they had 5 joint returns previously prior to the tax year at issue.

A. Married Filing Joint Status

- **3. Tacit Consent to a Joint Filing**

Example

- **Jones v. Comm., CA-9 2022-1 USTC 50111(2/3/22).** The 9th Circuit Court of Appeals found the Tax Court did not err in concluding the taxpayer tacitly consented to the filing of a joint return. A joint tax return signed by one spouse on behalf of the other is valid so long as the nonsigning spouse tacitly consented to the filing. That is a facts and circumstance examination. In this case this taxpayer who did not sign tacitly agreed to the filing she provided her spouse with her W-2 and other tax information and she failed to file a separate return as married filing separate.

B. Qualifying Child

- **1. Definition of Qualifying Child – Section 152 (c).** The definition of a qualifying child is required for the child tax credit, child care credit, and education credits. To satisfy the definition of a qualifying child the taxpayer must satisfy the following:
  - The child must be related to the taxpayer (Section 152 (f) (1))
  - The child must not have obtained the age of 19 by the end of the calendar year or must be a student who has not attained the age of 24 by the end of the calendar year and must be younger than the taxpayer. (Section 152 (c) (3) and (f) (2) an exception to this exists for a dependent who is totally personally disabled at any time during the tax year.
  - The child must have the same place of abode as the taxpayer for more than one-half the year (Section 152 (c) (1) (B))
  - The child must not provide more than one half is support for the tax year (Section 152 (c) (1) (D))
  - The child must not have filed a joint return other than a claim for refund (Section 152 (d) (1) (E))

Example

- **Turner v. Comm., TC Memo 2024 – 20**. Taxpayer’ s home was not the principal place of abode for more than one half of the year of a qualifying child or any other person who might qualify as petitioner's dependent. That being so, petitioner is not entitled to head of household filing status for the tax year at issue. The taxpayer did not qualify for head of household status because the household was not the principal place of abode for her and the grandchild for more than one half the year. The child did not meet the definition of a qualifying child.. The IRS is allowed to change her filing status from head of household to single and adjusted the standard deduction accordingly.

B. Qualifying Child

- 2. Section 152(b)(3)(A) provides that a “dependent” does not include certain nonresident aliens.

Example

- **Di Giorgio Sr., v. Comm., TC Memo 2023-44**. The taxpayer was not entitled to a dependency exemption deduction for the children of his second wife who, during the stated year, were nonresident aliens and had not been adopted by the taxpayer.

C. Qualifying Relatives

- 1. Section 152(a) defines a "dependent" to include a "qualifying relative."

- 2. To be a qualifying relative, an individual must:
  - Not be a qualifying child of the taxpayer nor anyone else's qualifying child.
  - The person must either have lived with the taxpayer for the entire year as a member of the household or be related to the taxpayer
  - Have gross income less than the exemption amount for the calendar year and
  - Receive more than one-half of their support from the taxpayer claiming the individual as a qualifying relative. (See Section 152(d)(1)(C))

C. Qualifying Relatives

- 3. For 2024, the exemption amount will be $5,000 (Rev. Proc. 2023 – 34; IR 2023 – 208)

- 4, For 2025, the exemption amount will be $5200. (Rev. Proc. 2024 – 40; IR 2024 – 273)

D. Head of Household

- **1. Rule**. A U.S. citizen or resident alien who is unmarried or considered unmarried at the end of the tax year and who maintains as his or home a household that is the principal place of residence for certain qualifying individuals for more than one-half the year may file as a Head of Household (See Section 2(b)(1)).

- **2. Qualifications**. To qualify as a Head of Household:

D. Head of Household

- a. A U.S. citizen or resident alien must be married or considered unmarried on the last day of the tax year.
- b. The taxpayer files a separate tax return;

D. Head of Household

- c. Taxpayer pays more than one-half the cost of maintaining his or her household for the tax year. It is NOT sufficient that the taxpayer merely pays the expenses of the household to qualify for Head of Household status;

- d. The taxpayer's spouse is not a member of the household during the last six months of the tax year; and

- e. The household is, for more than six months of the year, the principal home of the taxpayer's child for whom the taxpayer can claim a dependency exemption or could claim such an exemption except for the special rules for divorced parents. (i.e.; either qualifying children or qualifying relatives).

Example

- **Pangelina v. Comm ., TC Memo 2024 – 5**. Taxpayer filed as head of household claiming three qualifying children as dependents.. The Service determined the taxpayer was entitled to single status as the taxpayer offered no evidence that he was entitled to head of household status nor that the three dependents were qualifying children.

D. Head of Household

- **3. Tie–Breaking Rules For Qualifying Child -Section 152(c)(4).** If an individual can be claimed as a qualifying child) by two or more taxpayers for a tax year beginning in the same calendar year, the tie-breaking rules.

- a. If two or more taxpayers may claim an individual as a qualifying child for a tax year beginning in the same calendar year, the individual will be treated as the qualifying child of the taxpayer who is:
  - a parent of the individual, or
  - if the parent of the individual does not apply, the taxpayer with the highest adjusted gross income (AGI) for that tax year. (See Section 152 (c) (4) (A)

D. Head of Household

- b. If more than one taxpayer who can claim an individual as a qualifying child is a parent of the individual, then any one of those parents may claim the individual as a qualifying child. (See Prop. Reg. 1.152 – 2 (g) (1) (i))

- c. If the parents do not file a joint return together, the child will be treated as the qualifying child of:
  - the parent with whom the child resided for the longest period of time during the tax year, or
  - if the child resided with both parents for the same amount of time during the tax year, the parent with the higher AGI. (See Section 152 (c) (4) (B))

D. Head of Household

- d. The same rule will apply where a child is a qualifying child of both parents who are registered domestic partners or partners in a similar formal relationship that isn't a marriage under state law.
- e. If an individual's parents can claim the individual as a qualifying child but no parent does, another taxpayer may claim the individual as a qualifying child, but only if that taxpayer's AGI is higher than the highest AGI of any parent of the individual. (See Section 152 (c) (4) (C)))

D. Head of Household

- **4. Children of Divorced or Unmarried Parents – Form 8332**

- a. A taxpayer who is the custodial parent of either a qualifying child or qualifying relative who were ever married to the qualifying child or qualifying relatives non-custodial parent, may use Form 8332: Release of Claim to Exemption for Child of Divorced or Separated Parents to release the claim for the child or relative exemption to the Noncustodial Parent.

D. Head of Household

- b. The custodial parent completes the form and signs it. The custodial then provides the form to the noncustodial parent who must attach the form or similar statement to the tax return for each year the exemption is claimed.
- c. Part I of the form is completed if the custodial agrees to release the child exemption for the current tax year.
- d. Part II is to be complete if the custodial agrees to release the child exemption for any future years. The specific years must be stated on the form.

D. Head of Household

- e. The custodial and noncustodial parents are determined under Section 152 (e) and not under the decree of divorce or separation agreement. This is for divorces or separations that occurred after July 2, 2008. The rationale was to eliminate Private Letter Rulings on the determination of custodial and noncustodial. As such, a noncustodial parent cannot attack pages from the divorce decree to demonstrate an ability to claim a child.

- **f. Custodial Parent**. The custodial parent is generally the parent who had custody of the qualifying child or qualifying relative for most of the tax year. Custody is referenced under Publication 501.

D. Head of Household

- **g. Custody**. A parent can be considered to be a custodial parent if the child resides with the parent for the greatest number of nights during the tax year. A child is treated as having lived with a parent for a night the child sleeps at the parent’s home regardless of whether or not the parents are present or in the company of a parent with whom the child does not sleep at a parent’s home (vacation). If a parent works nights then the test would refer to days. If a child is not with either parent on a particular night the child is treated as living with the parent with whom the child normally would have lived for that night. An example would be a child staying over at a friend’s house. However, if it cannot be determined with which parent the child normally would have lived or if the child would not have lived with either parent that night, the child is treated as not living with either parent for that particular night.

C. Qualifying Relatives

- **h. Support Test**. The period is also deemed to be the custodial parent if they provided over half of the child support during the tax year. Specifically, the custodial parent is treated as having provided over half of the child support if the child received over half of the total support for the year from one or both of the parents and the child was in the custody of water both parents for more than half the year. For the support test to apply, the parents must be either divorced or legally separated under a decree of divorce or separation maintenance agreement, separated under a written separation agreement, or living apart at all times during the last six months of the year.

C. Qualifying Relatives

- **Note**: The support test does not apply to parents who never married. In addition, if the support test applies and the other four dependency test are also met, the custodial parent can claim the exemption.

- **i. Exception**. The custodial parent will not be treated as having provided over half of the child support if:
  - The custodial parent agrees not to claim the child exemption by signing Form 8332 or providing a similar statement.
  - The child is treated as having received over half of his or her support from a person under a multiple support agreement.
  - A pre-1985 divorce decree a written separation agreement states that the noncustodial parent can claim the child as a dependent. Should be noted the noncustodial parent in this case must provide at least $600 for support during the year. This only applies to pre-1985 agreements.

E. Nonresident Filing Issues

- 1. For the filing of 2024 returns, a nonresident alien, foreign trust or foreign estate will use Schedule P to report information and calculate the gain or loss of a transfer of an interest in a partnership that is either directly or indirectly engaged in the conduct of a trade or business within the United States or holds any US real property interest.

- 2. There is a revised Spanish version of the Form 1040 – NR for this upcoming tax season.

E. Nonresident Filing Issues

- 3. A nonresident alien is generally not entitled to receive a tax refund for deductions from taxable income involving personal exemptions under Section 151 (d) (5) (B) and Section 873 (b) (3). Specifically, personal exemptions prior to the tax cuts and jobs act were allowed with respect to income that was effectively connected with the conduct of trade or business in the United States.

Example

- **Bell v. US, 1:2022 CV 01875 (Fed. Cl 2024).** The taxpayer is a nonresident alien seeking a refund of over $414,000. Taxpayer claimed he was entitled to personal exemption deductions without such reductions being reduced to zero under the Tax Cuts and Jobs Act and without it being associated with income effectively connected with US trade or businesses. Taxpayer argued that Congress's intent under the Act to disallow the deduction was for US citizens and not for nonresident aliens. The taxpayer is entitled to exemptions associate with income effectively connected with the trade or business in the United States.

F. Form 8867: Paid Preparer's Due Diligence Checklist

- 1. Form 8867, the tax preparer due diligence checklist for determining eligibility of Head of Household Status, EITC, CTC/ACTC and AOTC has been revised.

- 2. For future years, a tax preparer not only must retain a copy of the form but any applicable `from later of:
  - The due date of the tax return (not including extensions).
  - The date the return was filed (if the taxpayer is signing a tax return prepared electronically filing the return).
  - The date the return was presented to the taxpayer for signature.
  - The date the taxpayer submitted to the tax preparer the return for which the taxpayers responsible for. Meaning, the signing of the return authorizing electronic filing.

G. IRS Publication 536

- 1. IRS Publication 536 used to provide guidance on what the taxpayer would do when the taxpayer has more deductions that income in a given year. In essence the publication described how to compute the net operating loss.

- 2. The IRS announced that Publication 536 will no longer be provided.

H. Estimated Tax Payments

- 1. Even if no tax return is filed for several years, estimated tax payments are still a requirement if liability exists.

Example

- **Standifird v. Comm., TC Memo 2024 – 30**. The taxpayer did not file his individual income tax return for four years or make any estimated tax payments during that timeframe. The IRS determined income tax efficiencies and asserted additional taxes such as failure to file penalties and failure to pay estimated taxes. The IRS produced the taxpayer’s transcript confirming no returns were filed in the court concluded the taxpayer was liable for the additions to tax including estimated tax penalties for not making quarterly estimated tax payments.

SECTION II:

INCOME AND EXCLUSIONS

I. Wages and Compensation

A. Social Security Wage Base

- 1. The Social Security Administration (SSA) is projecting that the Social Security wage base will increase from $160,200 to $168,600 in 2024 in all three of its forecasts. This is the second revision for 2024.

- 2. For 2025, the Social Security Administration announced the annual cost-of-living adjustment to the maximum amount of earnings is subject to the Social Security Tax will be $176,100.

B. Work Life Referral Services – IR 2024 – 110; Fact Sheet 2024 – 13.

- 1. The IRS has issued frequently asked questions (FAQs) on the tax treatment of work-life referral services (sometimes called caregiver and caretaker navigation services), which are employer-funded benefits that help employees find resources and support for personal, work, or family challenges.

- 2. These services are typically integrated into employee assistance programs or bundled with other employer services and can include guidance on accessing child and elder care, health care, financial and legal services, and assistance with related paperwork and administrative tasks. In the announcement, the IRS provides that these services are de minimis fringe benefits, exempt from income and employment taxes (FICA, FUTA, and income tax withholding).

C. Frivolous Exclusion of Wages from Gross Income

Examples

- **Wendell v. Comm., No. 4784-23 (U.S.T.C. May. 13, 2024).** Taxpayer is a licensed physician and was employed by an anesthesiologist firm. He was issued a W-2 that showed more than $500,000 in wages and $140,000 in federal withholdings. The taxpayer for the year issue reported no taxable income but only reported the federal withholdings claiming a refund of the hundred $40,000.. In a statement attached the return date indicated that there was no federal taxable activity constituting taxable income. Section 61 indicates a gross income consist of all income from whatever source derived including wages or monies paid for services. Taxpayers argue that the payments received were not for services rendered.

- **Mactaggart v. Comm., CA 5, 132 AFTR 2d 2023 – 5379.** The Fifth Circuit upheld the Tax Court's decision assessing deficiencies against the taxpayer where the taxpayer offered only frivolous arguments as to why the income he received for services was not taxable. The taxpayer argued that the income received should not be taxable because he was a nonresident alien despite working in the United States.

Examples

- **Jenkins v. Comm., TC Memo 2023 – 102.** The taxpayer had unreported wages and retirement distributions even though he received Forms W-2 and 1099. The taxpayer indicated he did not pick up the amounts because the IRS failed to credit payments he made in prior years and until that was done he was not going to file.

- **Harvey v. Comm., TC Memo 2023 – 95.** The taxpayer states that while he received wages he is not liable to pay federal taxes citing Section 7701 (a) (9) which defines the term United States to include only the states and the District of Columbia and asserting that the term income is not defined under Title 26 of the US code. The taxpayer also states that the Supreme Court has repeatedly ruled the federal government cannot levy a tax on one's property and ultimately one's labor.

- **Hatfield III v. Comm., TC Memo 2023 – .93.** Taxpayer argued he is a US citizen and not subject to income tax as such wages are not subject to taxation.

D. Vesting of Restricted Stock Units Are Considered Wages at Time of Vesting – CCA 20237014

- 1. The Chief Counsel's Office address the tax treatment of restricted stock units paid to a US corporation's employees while they were performing services in the United States but who later transferred to a controlled foreign corporation and are performing services for that corporation solely outside of the United States at the time the restricted stock vested.

- 2. The chief counsel's office advised that the restricted stock units are considered wages for FICA purposes on the vesting date pursuant to Reg Section 31.312 (v) (2) – 1 (e) (7). The chief counsel also indicated the source of the restricted stock units income needs to be determined under the time basis method as indicated under Regulation Section 1.861 – 4 (b) (2) (ii) (E).

E. Changes Under SECURE 2.0 Impacting Amounts Reported on Form W – 2 (FS – 2024 – 29)

- 1. The IRS has reminded businesses that starting in tax year 2023 changes under the SECURE 2.0 Act may affect the amounts they need to report on their Forms W-2. The provisions potentially affecting Forms W-2 (including Forms W-2AS, W-2GU and W-2VI) are:
  - De minimis financial incentives;
  - Roth Savings Incentive Match Plan for Employees (SIMPLE) and Roth Simplified Employee Pension (SEP) Individual Retirement Arrangements (IRAs); and
  - Optional treatment of employer nonelective or matching contributions as Roth contributions.

E. Changes Under SECURE 2.0 Impacting Amounts Reported on Form W – 2 (FS – 2024 – 29)

- 2. Businesses can now complete and print various copies (excluding Copy A) of Forms W-2 (including Forms W-2AS, W-2GU and W-2VI) on IRS.gov for recipients. Any information entered on one copy (excluding Copy A) will automatically appear on the others. Copy A cannot be completed online to print and file with the Social Security Administration.

- 3. If a business filed 2023 Forms W-2 without following these new guidelines, they may need to file Form W-2c to correct any errors.

II. Interest Income

A. Income from US Savings Bonds used for Qualified Higher Education Expenses (Series EE & I Savings Bonds)

- 1. For 2024, 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 $96,800 ($145,200 on a joint return). (See Rev. Proc. 2023 – 34)

- 2. For 2025, 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 $99,500 $149,250 on a joint return). (See Rev. Proc. 2024 – 40)

B. Taxable interest or Nontaxable Interest

- 1. Interest paid on a child support arrearage is taxable interest under Section 61 (a) (4). The taxpayer has the burden to demonstrate such payment is either child support or alimony pursuant to judicial documents.

Example

- **Rodgers v. Comm., TC, 2023 – 56.** The amount of income reported on Form 1099-INT and which the taxpayer admitted receiving was taxable interest income, not nontaxable child support as she claimed. While payment was made in connection with child support arrearages that the ex-husband owed the taxpayer, the record clearly showed it was interest. The taxpayer's argument that the arrearage principal may have been larger than the amount the state determined was irrelevant, in that any increase in principal would just have resulted in increased interest. The taxpayer received the amounts under the state of Alabama that issued child support payment and said state issued Form 1099 – INT taxpayer acknowledges ex-husband did not make timely child support payments that he was obligated to make and that the state court order directed payments of child support and interest due to being in arrears.

C. Income in Respect of Decedent: Taxation of Accumulated Interest on Savings Bonds

- 1. Generally, the taxpayer who inherits a savings bond containing accrued interest must recognize the accrued interest in gross income in the year of receipt or redemption of the bond.

Example

- **Hitchman v. Comm., TC Summary 2023 – 18.** The Tax Court held that a taxpayer who inherited a savings bond from his father, then had the bond reissued in his name and redeemed it, had to include the accumulated interest on the bond in his gross income. The court rejected the taxpayer's argument that his interest income was limited to the interest that accrued from the time he had it reissued in his name; the court found that because the taxpayer's father did not report any interest income on the bond while he owned it, the interest therefore accumulated, and when the taxpayer redeemed the bond the accumulated interest was includible in his income as income in respect of a decedent under Section 691(a).

D. Nontaxable Loan Proceeds

- 1. Loan associated with a nontaxable event must still meet valid debtor creditor relationship for interest to exist.

Example

- **Aulisio Jr. v. Comm., TC Memo 2024 – 29.** Taxpayer, a CPA, failed to report interest income from a trust indicating that the amount received representing nontaxable loan proceeds rather than interest income. Taxpayer argued that his friend who prepared his return mistook loan deposits as income. The loan was not evidenced by any instrument and there was no valid debtor creditor relationship to establish the loans existed much less to be nontaxable.. Taxpayer went back and amended the return to include the interest to avoid penalties. The avoidance of the penalties did not prevail.

III. Qualifying Dividend Income and Capital Gains

A. 2024 Rates – Rev. Proc. 2023 – 34; IR 2023 – 208

- 1. For 2024, the 0% capital gains rate applies to adjusted net capital gain of up to:
  - $94,050 for joint returns and surviving spouses
  - $47,025 for single and married taxpayers filing separately
  - $63,000 for head of household
  - $3,150 for estates and trusts

A. 2024 Rates – Rev. Proc. 2023 – 34; IR 2023 – 208

- 2. For 2024, the 15% capital gains tax rate applies to adjusted net capital gain over the amount subject to the 0% rate, and up to:
  - $583,750 for joint returns and surviving spouses
  - $291,850 for married taxpayers filing separately
  - $551,350 for heads of household
  - $518,900 for single individuals
  - $15,450 for estates and trusts

- 3. The 20% capital gains tax rate applies to adjusted net capital gain over the above 15% rates.

B. 2025 Rates – Rev. Proc. 2024 – 40; IR 2024 – 273

- 1. For 2025, the 0% capital gains rate applies to adjusted net capital gain of up to:
  - $96,700 for joint returns and surviving spouses
  - $48,350 for single and married taxpayers filing separately
  - $64,750 for head of household
  - $3,250 for estates and trusts

- 2. For 2025, the 15% capital gains tax rate applies to adjusted net capital gain over the amount subject to the 0% rate, and up to:
  - $600,050 for joint returns and surviving spouses
  - $300,000 for married taxpayers filing separately
  - $566,700 for heads of household
  - $533,400 for single individuals
  - $15,900 for estates and trusts

B. 2025 Rates – Rev. Proc. 2024 – 40; IR 2024 – 273

- 3. The 20% capital gains tax rate applies to adjusted net capital gain over the above 15% rates.

C. Substantiation

- 1. Taxpayers may rely on third-party reports (Form 1099 – DIV and Form 1099 – INT) showing income when there is not a reasonable dispute as to the accuracy of said forms.

Example

- **Scott v. Comm., TC Memo to 2023 – 141**. Taxpayer's Form 1040 was the subject of a routine audit examination for tax year 2019. The return omitted Form 1099 – DIVs. The evidence indicated that the taxpayer had received the dividends but failed to report dividends and capital gain distributions in the amount of $90 and $644. An additional tax liability was assessed. The taxpayer filed a petition with the court. It should be noted the taxpayer also received a distribution the form of Form 1099 – R and claimed an exemption from the tax. That exemption was denied. The taxpayer claimed that her income had not changed over 10 years making the same amount over that time. The taxpayer did not dispute receiving the forms nor could she provide any evidence disputing the amounts included income other than saying I got them a pass and was not aware I need to report them on the return.

C. Substantiation

- **2. Notice 2024 – 11; 2024 – 2 IRB: List of Treaties Meeting Qualified Foreign Dividend Requirement Updated**

C. Substantiation

- a. The IRS has issued a notice updating the list of treaties related to qualifying dividends treatment. Under Section 1 (h) (11), a dividend paid to an individual shareholder from either domestic corporation or a qualified foreign corporation is subject to the reduced rate associated with capital gain treatment. The notice is effective with respect to dividends paid to the country of Chile after December 19, 2023. With respect to the country of Hungary is applicable for dividends paid on or after January 8, 2023 and with respect to Russia for dividends paid on or after January 1, 2023. The other countries and their effective dates are included in the notice.

Examples

- **Saccato v. Comm., TC Memo 2023 – 96.** The taxpayer argued that sales proceeds from the property did not belong to him. The taxpayer purchased real property but had the warranty deed recorded the transfer listing the taxpayer's name as trustee of a trustee established. The deed did not indicate any consideration paid for the purchase of the property. The trust transferred the property to other individuals including the taxpayer again with no consideration. The taxpayer indicated the purpose of the transaction was to facilitate a subsequent sale while obscuring the fact the taxpayer was the true owner of the property. The property was subsequently sold and a check was issued to 1/3 party and not the trustee of the trust. The IRS examined the transaction and indicated the sale of the property would be capital gains attributable to the taxpayer as the taxpayer was the true owner of the property. Outside of the deed, there was no evidence of the existence of the trusts creating an evasive behavior to have the gain attributable to the taxpayer individually.

Examples

- **Kamal v. Comm., TC Memo 2023 – 80**. Married couple had unreported income from the sale of the husband's stock. Husband admitted receiving amounts from the sale of stock in connection with a merger between his former employer in its parent company. The taxpayer did receive Forms 1099 – B showing net capital gains from stock trades. The taxpayer failed to offer any argument or evidence to dispute receiving capital gains and dividends on the matter. The court did give him a credit proportion that was considered qualifying dividends in nature.

E. Virtual Currency and Digital Assets

- **1. Final Regulations on Reporting Requirements for Digital Assets – TD 10000**

- a. The Service has issued final regulations for reporting digital assets that provides guidance on information reporting and determination of the amount realized and basis for certain digital asset sales and exchanges.

- b. The regulations require custodial brokers to report various sales and exchange transactions beginning in 2026 is for transactions in calendar year 2025.

E. Virtual Currency and Digital Assets

- c. The final regulations require reporting by custodial brokers, who are brokers that take possession of digital assets being sold by their customers. Such brokers include operators of custodial digital asset trading platforms, certain digital asset hosted wallet providers, digital asset kiosks, and certain processors of digital asset payments. Real estate professionals are also required to report the fair market value digital assets paid by buyers and received by sellers in real estate transactions with closing dates on or after January 1, 2026.

- d. The final regulations do not require that taxpayers report transaction identifications on their Form 1099 – DA. However, they must collect the information and retain it for seven years and make it available to the IRS upon request.

E. Virtual Currency and Digital Assets

- e. The Regulations provide for backup withholding.

- **2. Notice 2024 – 57.** The notice provides that brokers are not required to file information returns and furnish payee statements for certain digital assets. These include these include the following:

E. Virtual Currency and Digital Assets

- Wrapping and unwrapping transactions that involve the transfer of a single type of digital asset native to a secured distributed ledger in return for another digital asset that is redeemable solely for a digital asset and is identified coal to the digital asset except it is wrapped in executing contract. It also involves the transfer or redemption of a digital asset in return for another digital asset regardless of whether other digital assets attributable to the transfer are also received or credited.
- Liquidity Provider Transactions that involve the transfer of a digital asset into an automatically executing contract and the receipt of the different digital asset that represents an interest in a pool of digital assets
- Staking transactions which above the transfer of a digital asset from an automatically executing contract regardless of whether the receipt includes the receipt or crediting of additional digital assets as a validation or reward for the use of the digital asset.
- Digital asset market participants such as lending of digital assets
- The short sales of digital assets

E. Virtual Currency and Digital Assets

- **3. IR 2024 – 12 and Announcement 2024 – 4**. The IRS has issued an announcement informing businesses that they do not have to report the receipt of digital assets in the same way they must report the receipt of cash until the IRS issues final regulations under Section 6050I. The Infrastructure Investment and Jobs Act revised the rules requiring taxpayers engaged in a trade or business to report cash receipts of more than $10,000 by adding digital assets to the definition of cash. However, this provision of the new law requires the IRS to issue regulations before it goes into effect. Until the IRS publishes regulations, businesses that receive digital assets will not be required to include those digital assets when determining whether the cash value received in a transaction exceeds the $10,000 reporting threshold and must be reported on Form 8300, Report of Cash Payments over $10,000 Received in a Trade or Business, within 15 days of receiving the cash.

E. Virtual Currency and Digital Assets

- **4. The IRS has released a draft of the 2025 Form 1099-DA (Digital Asset Proceeds From Broker Transactions), an information return that reports digital asset transactions to be furnished by brokers.**

- a. Beginning January 1, 2025, the new form is generally expected to be included with federal income tax returns by taxpayers who answer "yes" to the question asking if they, at any time during the relevant tax year, received, sold, exchanged, or disposed of a digital asset or financial interest in a digital asset.

E. Virtual Currency and Digital Assets

- b. Common digital assets include cryptocurrencies, stablecoins, and non-fungible tokens. Form 1099-DA reflects proposed regulations released last year under Proposed Reg 1.6045 – 1. that sought to clear up confusion around digital asset issues such as how the definition of a "broker" under the Infrastructure Investment and Jobs Act applies to centralized exchanges, payment processors, and decentralized finance centers.

- **5. Rev. Proc. 2024 – 28**. This Revenue Procedure will permit taxpayers to rely on any reasonable allocation of units of unease basis to a wallet or account that holds the same number of remaining digital asset units based on the taxpayer's records of such unused basis and remaining units. Allocation must be reasonable in nature and must be made as of January 1, 2025

E. Virtual Currency and Digital Assets

- **6. Gift Tax Issues.** Under IRS Tax Tip 2023 – 45, if a transaction involving a digital asset is a gift Form 709: US Gift (and Generation Skipping Transfer) return must be filed. Assuming the gift exceeds the threshold of exclusion.

- **7. Notice 2023 – 50**. The IRS in this notice announced it intends to issue guidance on the tax treatment of nonfungible tokens (NFTs) as collectibles. In the notice, the IRS states that it will utilize a look-through analysis in determining if an NFT should be treated as a collectible; i.e., it will analyze whether an NFT's associated right or asset falls under the definition of a collectible in the Code to make the determination. For example, if a gem is a collectible under Sec. 408(m), then an NFT certifying ownership of a gem also is a collectible.

E. Virtual Currency and Digital Assets

- a. An NFT is a unique digital identifier that is recorded using distributed ledger technology and may be used to certify the authenticity and ownership of an associated right or asset. This is often associated with blockchain technology and other distributed ledgers that use digital systems to record, share, and synchronize transactions where the details of the transactions are recorded simultaneously on multiple networks. An EFT can be associated with the entry of data encoded on a distributed ledger that is used to identify ownership of the tokens and NFT falls in that category.

E. Virtual Currency and Digital Assets

- **8. CCA 202302011. No Deductible Loss for Substantial Decline in Cryptocurrency Value**. The taxpayer claimed a worthless stock deduction under Section 165. This section provides a deduction for losses that are evidenced by closed or completed transactions, fixed by identifiable events and actually sustained during the tax year. The taxpayer is not to have abandoned or otherwise disposed of the Cryptocurrency and the Cryptocurrency was not worthless because it still had value. As such, the taxpayers loss was denied. The CCA further indicated that even if the taxpayer sustained a loss, the loss will be disallowed because of the suspension of the 2% AGI miscellaneous deduction associate with itemized deductions.

E. Virtual Currency and Digital Assets

- This deduction is associated with a capital asset becoming worthless during the tax year. Section 165 (g) (2) defines a securities a share of stock in a corporation, a right to subscribe for, or to receive, a share of stock in a corporation or evidence of indebtedness issued by a corporation or a government/political subdivision thereof with interest coupons or in a registered foreign. Cryptocurrency is none of these items listed in Section (g) (2) and as such does not apply. This is not to say that a capital gain or loss cannot occur in a Cryptocurrency but it is not within the definition of a security for purposes of being worthless.

E. Virtual Currency and Digital Assets

- **9. Protocol Upgrade – CCA 202316008**. The taxpayer who held 10 units of cryptocurrency native to the blockchain distributed ledger that underwent a protocol upgrade that changed the mechanism by which future transactions were validated, did not realize gain or loss on those units as a result of protocol upgrade. The protocol upgrade did not alter past transactions or blocks previously validated and added to the blockchain, including subject units.

- **10. Rev. Rul. 2023 – 14. Proof of State Validation Rewards**

E. Virtual Currency and Digital Assets

- a. Taxpayers must include the fair market value (FMV) of proof-of-stake validation rewards in their gross income for the tax year in which they gain dominion and control over the validation rewards.
- b. The ruling applies to cash-method taxpayers who stake cryptocurrency native to a proof-of-stake blockchain and receive additional units of cryptocurrency when validation occurs. The FMV is determined as of the date and time the taxpayer gains dominion and control over the validation rewards.
- c. Proof of stake is a way to decide which user or users validate new blocks of transactions and earn a reward for doing so correctly.
- d. Ethereum, the second-largest digital asset, switched last year to proof of stake from proof of work. Bitcoin uses proof of work.

G. Qualified Opportunity Zone (QOF)

- **1. Reporting Requirements**

- a. A taxpayer must annually report any QOF investment, as well as any deferred capital gains and the disposition of any QOF investments during the tax year, to the IRS on a Form 8997: Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments.

- b. Form 8997 must be attached to the taxpayer's timely filed federal tax return, including extensions

- c. The failure to file Form 8997 will result in an inclusion event that terminates the taxpayer’s qualifying investment in a QOF and triggers recognition of any deferred gain.

G. Qualified Opportunity Zone (QOF)

- d. In addition, an entity that elected (or is electing) to be a QOF must annually file Form 8996: Qualified Opportunity Fund, with its timely filed federal tax return, including extensions.

- e. Form 8996 is used to report that the QOF meets the investment standards in Section 1400 Z – 2 or to figure the penalty if the entity fails to meet those investment standards.

- f. A QOF must file Form 8996 even in years the entity has no taxable income.

G. Qualified Opportunity Zone (QOF)

- **2. Deferral Income Recognition – PLR 202249005**

- a. The taxpayer's gross income from the sale of stated parcel that occurred during a startup period could be treated as gross income derived from the conduct of a trade or business in a qualified opportunity zone satisfying deferral provide the taxpayer adopted a new or revised working capital plan within hundred 20 days of the end of the qualified disaster incident timeframe that satisfies the requirements of Code Section 1400 Z – 2 and that such plan utilizes those sales proceeds in a manner that the completion of the spending occurs in the working capital timeframe.

H. Like-Kind Exchanges

- 1. Like-kind exchange provisions were previously finalized under TD 9935 (IR 2020 – 262).

- 2. Property is real property for purposes of a like-kind exchange if, on the date it is transferred, the property is classified as real property under local or state law jurisdiction where the property is located. For example, state or local law would ascertain whether the property included a ditch or irrigation company. The characterization of the property as real property under state or local law definition also applies to personal property and intangible property. This is a change from the proposed regulations which did not give any consideration to state or local regulations.

H. Like-Kind Exchanges

- 3. Property is classified as real property if the property is:
  - Classified under state and local law as a general rule;
  - Specifically listed as real property in the Final Regulations or
  - Considered real property based on facts and circumstances.

- 4. A determination that properties personal property under state or local law does not preclude the conclusion that the property is real property for purposes of the final regulations.

H. Like-Kind Exchanges

- 5. Real property included land, land improvements, and improvement to land including both permanent structures and structural components. Inherent structures are buildings or other structures personally fixed to the real property that would remain affixed for an indefinite period of time.

Example of Real Property Determination for Like kind Treatment

- **PLR 202309007**. Ranch owner performing a like-kind exchange of real property with water rights was allowed deferred gain treatment. Water rights fell within the regulations of Section 1031 as real property on the condition that the properties are held for productive use in a trade or business or investment.

H. Like-Kind Exchanges

- 6. With regards to tangible property if the property is currently affixed to real property and will ordinarily remain affixed to the property for an indefinite period of time then the property is considered inherently permanent or inherently permanent structure and thus real property for purposes of the like-kind exchange regardless of the purpose or use of the property or whether it contributes the production of income.

- 7. A structural component is characterized as real property if it is integrated into an inherently permanent structure regardless of whether the structural component contributes to the production of income. This means that machinery and equipment can be characterized as real property if they comprise an inherently permanent structure, a structural component, or real property as defined under state or local law.

H. Like-Kind Exchanges

- 8. Any inherently permanent structure building or structural component that is a distinct asset and is permanently affixed to the real estate and will ordinarily remain affixed to the real estate for an indefinite period of time. The determination of this is based on facts and circumstances.

- 9. Personal property is incidental to a real property exchange if, in a standard commercial transaction, the personal properties typically transferred together with the real property and the aggregate fair market incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement real property.

H. Like-Kind Exchanges

- **10. PLR 202335002**. Transferable development rights that the taxpayer proposes to use on property already owned qualify as real property and fall with the definition of a like kind which is exchange for another property that the taxpayer intended to sell as part of the transaction.

- 11. Section 1245 exchanges still requires recognition.

Example

- **Gerhardt v. Comm., 160 TC No. 9.** Taxpayers were not entitled to deferred gain on like-kind exchange involving the relinquishment of rental property in exchange for other rental property. Taxpayers did follow the like-kind exchange rules however stated gain had to be recognized as ordinary income because the property was depreciated under Section 1245.

I. Involuntary Conversion – Section 1033

- **1. General Rule**. If property (as a result of its destruction in whole or in part, theft, seizure, requisition, or condemnation) is compulsory or involuntarily converted into property similar or related in service or used to the property so converted no gain shall be recognized.

I. Involuntary Conversion – Section 1033

- **1. General Rule**. If property (as a result of its destruction in whole or in part, theft, seizure, requisition, or condemnation) is compulsory or involuntarily converted into property similar or related in service or used to the property so converted no gain shall be recognized.

Example

- **LTR 202318004**. The Service rules that payments a limited partnership received from an entity on an agreement were not eligible for nonrecognition of gain under Section 1033. The taxpayer had to finish clearing certain areas before receiving payment. In addition, the new assets once replaced constituted eligible replacement property with respect to the converted assets sharing the same function with the taxpayer’s current assets these did not make it dissimilar for exclusion of gain treatment.

I. Involuntary Conversion – Section 1033

- **1. Part Residence and Part Rental- Health Related**

- a. Section 121 (b) (5) allows for computing the gain exclusion on the sale of a residence by allocating Gay to periods of nonqualified use which references the game that is not excluded. These periods of nonqualified use do not include a period or timeframe of temporary absences which cannot be seated aggregate of two years due to a change of employment, health conditions, or other unforeseen circumstances. These are facts and circumstances examination.

Example

- **Webert v. Comm., TC Memo 2022 – 32.** Mrs. Webert was diagnosed with cancer, the same year she and her husband purchased the home in question. The Weberts alleged they resided in the home from 2005 through 2009 and experienced financial hardship due to Mrs. Webert's extensive medical treatments and related reduced working capacity. In 2009, the Weberts attempted to sell the home due to their medically related financial condition but were unsuccessful and decided to rent it from 2009 through 2015 as a last resort. The home was ultimately sold in 2015, resulting in a long-term capital gain, which they excluded from gross income under Sec. 121. The IRS disallowed the entire exclusion, arguing the Weberts did not use the home as their principal residence for at least two of the five years immediately preceding the sale. The Weberts argued that the sale was due to Mrs. Webert's health problems, therefore allowing a reduced exclusion under Sec. 121(c)(2)(B).

Example

- The IRS moved for summary judgment on the exclusion issue. The court ruled that the Weberts had not met the principal residence use requirement during the required 2010 through 2015 period and granted summary judgment on that point. However, it found that a reduced exclusion was plausible, given Mrs. Webert's numerous health issues precipitating the sale. Nonetheless, the court explained, that as the reduced exclusion is also based on periods within five years before the sale that the home is used as a principal residence, the result of this reduced exclusion also appeared to be zero in the Weberts' case. Because neither party had addressed whether, as a matter of law, Mrs. Webert's health was a material fact, the court did not grant the IRS summary judgment on this point.

I. Involuntary Conversion – Section 1033

- 2. Furnishings that are part of the sale of the residence are not part of the gain exclusion.

Example

- **Forte v. Comm., 2:18 –CV – 00200 (D. C. Utah, 6 – 21 – 21).** The District Court in Utah denied the taxpayer's motion for summary judgment related to the sale of the residence. The issue before the court was whether the taxpayers were entitled to exclude from their gross income part of the gain from the sale of their home and whether they were entitled to reduce the amount of the taxable gain realized on the sale of a different home by the amount paid for furnishings that were sold with that home. The court denied the motion because it found there were 2 genuine issues of material fact regarding whether the couple's sale of the home was due to unforeseen circumstances. Concerning unforeseen circumstances that would entitle the taxpayers to partial exclusion from the sale of the residence. The taxpayer's 2nd motion was denied and found they failed to cite any authority at the time to reduce the gain on the sale but all for furniture sold inside that home or with the sale of the home.

K. Bad Debt

- 1. A deduction is allowed for any debt that becomes worthless within the taxable year (See Sec. 166(a)(1)). A debt that becomes worthless, is a question of fact, but actual worthlessness is a condition that must be present for a bad debt deduction.

- 2. A debt is considered worthless when there are reasonable grounds for abandoning hope that the debt will be repaid and there is no longer any chance of the debt being collected. It is not necessary to wait until a debt becomes due to determine whether it is worthless, if the facts show that actual worthlessness exists before the due date (See Reg. Sec.1.166-2).

K. Bad Debt

- 3. Worthlessness is generally evidenced by an insolvent debtor not timely servicing the debt and refusing to pay any part of the debt in the future, declaring bankruptcy, or simply disappearing. A lawsuit is needed to enforce payment where the surrounding facts and circumstances indicate that, in all probability, the action would not result in an enforceable judgment in favor of the lender (Reg. Sec.1.166-2(b)).

- 4. However, the debt must be a bona fide debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money (See Reg. Sec.1.166-1(c)). The loan must be made with the understanding that it is to be repaid. Whether a debtor-creditor relationship exists depends on all the facts and circumstances, and generally no one fact is determinative. Factors to consider in determining whether there is a debtor-creditor relationship with a reasonable expectation of repayment are whether:

K. Bad Debt

– The existence of a written promissory note;
– Interest is stated and being charged on the note;
– There is a fixed schedule for repayment;
– Collateral exists in exchange for the note;
– A demand for repayment exists;
– The records reflect a loan;
– Repayments are or will been made; and
– The borrower was solvent at the time of the loan (See Hunt v. Comm., T.C. Memo. 1989-335).

K. Bad Debt

- **5. Nonbusiness Bad Debt**

- a. A nonbusiness bad debt must be totally worthless before it may be deducted, and it may be deducted by taxpayers other than corporations only as a short-term capital loss. (See Sec.166(d)(1)(B)).

- b. An S corporation's nonbusiness bad debt is a separately-stated item (Rev. Rul. 93-36)

K. Bad Debt

- c. The deduction for a nonbusiness bad debt must be taken in the year in which the debt becomes totally worthless (See Reg. Sec.1.166-5(a)(2)).

- d. When specific debts are deducted, there must be an explanatory statement attached to return, showing the name of the debtor and any related party interest to the taxpayer, the nature and amount of the debt, the date the debt became due to efforts made to collect the debt, and the reason for determining the debt to be worthless (See IRS Pub. 17).

K. Bad Debt

- **6. Business Bad Debt**

- a. A business bad debt is a loss from the worthlessness of the debt that was either created or acquired in association with the trade or business or closely related to the trade or business when he became partially or totally worthless. The debt is closely related to the business at the primary motive for incurring the debt is a business reason. A bona fide debtor creditor relationship is still required but the entire amount can be deductible if the debt is bona fide and in association with a valid trade or business.

- b. Business bad debts are primarily the result of credit sales to customers. They can also be the result of loans to suppliers, clients, employees or distributors.

L. Qualified Small Business Stock

- 1. Under Section 1202, noncorporate The taxpayers can exclude a certain percentage of gain from the sale or exchange of qualified small business stock (QSB) held for more than 5 years. Generally, the stock is stopped in a C corporation that was originally issued after August 10, 1993 and on the date of the stock issuance the corporation is a Qualified Small Business and the taxpayer acquired the stock in its original issue in exchange for money or property or compensation for services.

- 2. To be a qualified small business, the issuing corporation must satisfy that is conducting an active trade or business. It should be noted however that the code section provides a trade or business involving brokerage services is not considered an active trade or business for the exclusion.

Examples

- **PLR 202319013**. Taxpayer, an enterprise class application service software company that provides solutions tailored to technology challenges of their clients was not deemed to be a trade or business under Section 1202 for purposes of a 50% exclusion on the gain from the sale or exchange of qualified small business stock. The service determined the enemy was not a trade or business for Section 1202 where the taxpayer indicated the principal asset of the trade or business's reputation or skill of one or more of its employees.

IV. FORM 2555 – Foreign Source Income and the Foreign Income Exclusion

A. General Rule

- 1. U.S. citizens generally living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs. In order to qualify for these exclusions, a U.S. citizen must be either a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year or present overseas for 330 days out of any 12 consecutive month period. In addition, the taxpayer must have his or her tax home in a foreign country.

- 2. Individuals who are not bona fide residents of a foreign country and fail to meet the 330-day physical presence test may be treated as dual if eligible for a waiver. Waivers may be issued to individuals who:

A. General Rule

- Were bona fide residents of, or were present in, a foreign country for any period during which individuals were required to leave such foreign country because of war, civil unrest, or similar adverse conditions which precluded the normal conduct of business by such individuals; and

- Were able to establish to the IRS that the time requirements of the foreign earned income exclusion could reasonably have been expected to have been met but for the conditions of war, civil unrest, or similar adverse conditions. The IRS annually publishes a list of foreign countries where war, civil unrest, or adverse conditions exist, and where the individual taxpayer could not stay the full 330 days. (See Rev. Proc. 2014-25)

B. Foreign Earned Income Exclusion

- **1. Foreign Earned Income Exclusion Amounts – 2024 and 2025**

- a. The foreign earned income exclusion will be $126,500 in 2024. (See Rev. Proc. 2023 – 34; IR 2023 – 208)

- b. The foreign earned income exclusion will be $130,000 in 2025. (See Rev. Proc. 2024 – 40; IR 2024 – 273)

C. Foreign Housing Exclusion

- **1. IRS Notice 2024 – 31**. For 2024 the base housing amount is $20,240. Housing expenses of a qualified individual whose entire tax year is within the applicable period are limited to $37,950 in 2024. This notice also addresses high cost countries at the 30% rate and list those countries.

D. Factors to Consider in determining whether a taxpayer is a bona fide resident of a foreign country. (Linde v. Comm. , TC Memo 2017 – 180., Also see Sohurek , CA 7, 1962, 9AFTR 2d 883)

- 1. Over time, the courts have developed factors to ascertain whether a taxpayers a bona fide resident of a foreign country for purposes of the foreign income inclusion. Among the factors considered are the following:

D. Factors to Consider in determining whether a taxpayer is a bona fide resident of a foreign country. (Linde v. Comm. , TC Memo 2017 – 180., Also see Sohurek , CA 7, 1962, 9AFTR 2d 883)

- Intention of the taxpayer;
- Establishment of the taxpayer's home temporarily in the foreign country for an indefinite period;
- Participation in the activities of the chosen community;
- Physical presence in the foreign country consistent with the taxpayer's employment;
- Nature, extent and reasons for temporary absences from the taxpayer's temporary foreign home;
- Assumption of economic burdens and payment of taxes to the foreign country;
- Status contrasted to that of transient or sojourner;
- Treatment of the taxpayer's income tax status by his or her employer;
- Marital status and residence of the taxpayer's family;
- Nature and duration of the taxpayer's employment;
- Good faith in making the trip abroad, e.g., whether for the purpose of tax evasion

D. Factors to Consider in determining whether a taxpayer is a bona fide resident of a foreign country. (Linde v. Comm. , TC Memo 2017 – 180., Also see Sohurek , CA 7, 1962, 9AFTR 2d 883)

- b. No one factor supersedes others.

Examples

- **Diaz v. Comm., TC Memo 2024 – 45.** Taxpayers, a married couple, were not entitled to a foreign income exclusion because they failed to prove that the closing agreement they had entered into was invalid. The husband was employed as a US defense contractor on a joint military base in Australia and was asked to sign a closing agreement with the IRS. In that agreement, the taxpayer had waived the right to claim the foreign income tax exclusion with respect to wages earned at the base. In exchange, Australia agreed that no Australian income tax would be withheld from wages. The taxpayers argued the signatures appearing above their names were not there signatures but were forged. The husband was not a credible witness he testified to a very different version of the timeline at trial and he relied heavily on forensic evidence presented by different versions of his signature on various documents.

Examples

- The husband alleged reasons for refusing to sign the closing agreement was that he did not forfeit the benefits of claiming the income exclusion which made no economic sense. The taxpayers offered no explanation as to who would forge their signatures on the document. The forensic evidence regarding taxpayer signature pointed out that they failed to carry their burden of proving that there signatures on the documents were in fact forged. The taxpayers had waived their ability to claim the income exclusion accordingly.

Examples

- **Aubin v. Comm., TC Memo 2024 – 9.** Taxpayer who executed closing agreement in which he waived his right to claim Section 911 foreign earned income exclusion for years during which he was working abroad for defense contracting co. in Australia, Tax Court rejected his argument that Section 7121 didn't apply to said agreement. Although taxpayer claimed that agreement didn't address “an actual liability” because none of years to which it related had ended, and 2 of those years had not yet begun, agreements under Section 7121 covered any period ending before or after agreement became effective.

Examples

- **Henaire v. Comm., TC Memo 2023 – 131**. The taxpayer was not entitled to exclude foreign-earned income that the taxpayer had received in the form of wages for services she provided for the Corporation in Australia. The taxpayer began her employment with the organization she signed a closer agreement which she waived her right to make an election under section 911. The closing agreement was signed by the director of the IRS the taxpayer argued the director lacked authority to sign the agreement. The Tasker concluded the director signed the agreement acting as the authority under 1982 tax treaty between the US and Australia. Likewise, the taxpayer was not allowed to exclude the value of housing provided while she was working in Australia. The taxpayer did not establish that her employer provided her lodging for its own convenience that she was required to accept the logic as a condition of her employment or that the lodgings were on the employer's premises.

Examples

- **Clemons, Dr v. Comm., TC Memo 2022 – 95**. The taxpayer was a computer software professional and claimed a foreign income exclusion for the year he lived in Germany working as a subcontractor for a German software company. The taxpayer met factors to determine that his tax home was in Germany. However, the taxpayer could not exclude the housing costs because he did not have credible evidence to show he incurred them and that they were not reimbursed by the foreign employer.

V. Foreign Currency and Transaction Reporting

A. FBAR Rules

- 1. If the US person has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust or other type of foreign financial account and the amount exceeds $10,000 anytime during the year, the Bank Secrecy Act requires the US taxpayer to report the account yearly by filing electronically a Financial Crimes Enforcement Network (FinCEN) Form 114; Report of Foreign Bank and Financial Accounts (FBAR).

- 2. A US person, as well as certain domestic entities must file their report if:

- a. The person has a financial interest in or signature authority (or other authority that is comparable to signature authority) over one or more accounts in a foreign country, and

A. FBAR Rules

- b. The aggregate value of all foreign accounts exceeds $10,000 anytime during the calendar year.
- 3. An extension to file Form 114 is allowed for 6 month timeframe ending on October 15 to coincide with the filing of the taxpayers individual income tax return.
- 4. For taxpayers required to file Form 114 for the first time, any penalty for failure to timely request for file extension may be waived (See 2015 Highway Funding Bill)

A. FBAR Rules

- 5. Schedule B, Part III Foreign Accounts and Trusts. Form 1040, Schedule B, Part III must be completed if the taxpayer had over $1,500 of taxable interest or ordinary dividends; had a foreign account; or received a distribution from, or was a grantor of, or a transferor to, a foreign trust.

- 6. Line 7a and 7b of Part III requires a "yes" or "no" to the below two questions if the taxpayer has a signature authority over financial accounts in a foreign country of more than $10,000.

A. FBAR Rules

- 7. Form 114a, Record of Authorization to Electronically File FBARs must be signed by the taxpayer to allow third-party preparers to e-file the form. For those who are filing jointly, each spouse must sign the form. The form is not submitted with the electronic filing but is retained by the tax preparer for five years. Atty., CPAs, enrolled agents filing the FBAR on behalf of the client must register to become a BSA e-file or and file as an institution, rather than an individual.

- 8. There are exceptions to the FBAR reporting requirements. The exceptions are for the following US persons or foreign financial accounts:

A. FBAR Rules

- Certain foreign financial accounts jointly owned by spouses
- United States persons included in a consolidated FBAR
- Correspondent accounts
- Foreign financial accounts owned by a governmental entity
- Foreign financial accounts owned by an international financial institution
- Owners and beneficiaries of U.S. IRAs
- Participants in and beneficiaries of tax-qualified retirement plans
- Certain individuals with signature authority over, but no financial interest in, a foreign financial account
- Trust beneficiaries (but only if a U.S. person reports the account on an FBAR filed on behalf of the trust)
- Foreign financial accounts maintained on a United States military banking facility.
- Virtual currency

A. FBAR Rules

- 9. A person who holds a foreign financial account may have a reporting obligation even when the account produces no taxable income. The reporting obligation is met by answering questions on a tax return about foreign accounts (for example, the questions about foreign accounts on Form 1040 Schedule B) and by filing an FBAR.

B. Willful Failure to File and Penalty

- 1. A willful failure to file an FBAR may result in a civil penalty, which is assessed by the IRS. The penalty ranges from $129,210 up to 50% of the balance in the account at the time of the violation. (31 USC 5321(a)(5)(C))

- 2. Penalties for non-willful failures to file an FBAR are much lower: the maximum penalty is $12,921 per violation adjusted for inflation.

Example

- **US v. Hughes, CA 9 (8/21/2024) 134 AFTR2d 2024 – 5107.** The ninth circuit Court of Appeals ruled that a District Court applied the correct legal standard in determining that an owner of two New Zealand businesses old penalties for failing to disclose foreign bank account records and that the phages close was willful. The court determined willfulness can also be established by proof of recklessness as well as subjective intent. The taxpayer indicated she knew of the reporting requirement but did not do so

Example

- **US v. Schwarzbaum, CA 11 (8/30/2024) 134 AFTR2d 2024 – XXXX**. The 11th circuit found that eight willful penalty imposed on a taxpayer from filing the foreign bank account reporting requirements is subject to the eighth amendment excessive fines clause. The case involved a naturalized US citizen with bank accounts in Costa Rica and Switzerland for the taxpayer was aware of the filing requirement but he felt report accounts for three years resulting in penalties including a $300,000 penalty assessed on one low value account. The appellate court agreed with the District Court that the failure to file the reports was with recklessness and will for blindness. However, the penalty must be one that is to serve solely a remedial purpose.

Example

- The court noted that the willful penalties may be excessive irrespective of the magnitude of the financial injury caused to the government. The 11th circuit was not persuaded by the first circuit court indicating such penalties are not excessive because they are designed to reimburse the government for generalized harm relating to concealment of money. The court determined eighth amendment analysis should be on account by count basis not an aggregate test. In this case the court determined that the penalty of $100,000 for willful violations was constitutionally excessive as to one of the taxpayers accounts at the bounce that Had never exceeded $16,000 for any relevant year and $100,000 per your fine for this account is grossly disproportional. Many the fines other accounts were held to be constitutional.

Example

- **US v. Gaynor, 133 AFTR2d 2024 – 716**. A Federal District Ct. in Florida concluded that a deceased heiress did not willfully evade F bar reporting for three years where she answered no on the Schedule B regarding foreign accounts despite 31 million in a Swiss account and attempted to file back returns and FBAR through a silent disclosure provision.

- **US v. Kelly, 133 AFTR2d 2024 – 710**. The Sixth Circuit Court of Appeals agreed with the lower District Court that the taxpayer's failure to file the F bar report was willful and that he sought no professional advice prior to the closing of all his domestic bank accounts and opening accounts in Switzerland.

- **US v. Reyes, 133 AFTR2d 2024 – 468**. A District Court judge found the taxpayers willfully failed to disclose your Swiss Bank accounts concluding that their statement on Schedule B that they had no interest in a foreign bank account showed that they recklessly disregarded the FBAR reporting obligations even though they stated they did not review their tax return.

C. Nonwillful Penalties

- 1. A US person who fails to report a reportable account on an FBAR may be subject to nonwillful penalty. The maximum amount for a non-willful penalty is $10,000 adjusted for inflation.

- 2. The failure to comply with the reporting requirements will not result in a penalty if the person's failure was due to reasonable cause. That is a facts and circumstance examination.

C. Nonwillful Penalties

- 3. The Service will not impose a penalty for the failure to file the delinquent FBAR if the taxpayer properly reports on the tax return and paid all taxes on the income from the foreign financial accounts reported on the delinquent FBAR and the taxpayer had not previously been contacted by the IRS regarding income tax examination or request for delinquent returns for the years for which the delinquent forms are submitted.

- **4. Non- willful Penalty Applies on a Per Report Basis, not on a Per Account Basis.**

- **a. Bittner v. US S. Ct. 10 – 28 – 23) 131 AFTR2d 2023 – 437.** The US Supreme Court overturned the Fifth Circuit Court of Appeals and held that the $10,000 maximum County for the non-willful failure to file an F bar accrues on a per report basis not on a per account basis. The Ninth Circuit along with other district courts had held that the $10,000 penalty apply also on a per report basis and not in a per account basis. It is unclear the extent that this decision has a retroactive effect for assessments prior to 2023.

D. FBAR Penalties Are Not Taxes Subject To The Collection Due Process (CDP) Requirements

- 1. In a recent Tax Court case, the court determined that FBAR penalties assessed against the taxpayer were the taxpayer was informed that funds would be withheld from the monthly Social Security to satisfy the penalty is allowed and the taxpayer is not allowed a collection due process hearing.

- 2. Tax Court indicated that the penalties are authorized and imposed by Title 31 not Title 26 which is associated with the Internal Revenue Code as such the Tax Court lacked jurisdiction. Under Title 31, the treasury secretary may impose a civil pendant any person it fails to file an FBAR as required by law as the penalty is a non-tax debt owed to the United States. (See Jenner v. Co,,., 163 TC No. 7)

E. Treaties May Protect Against FBAR Penalties

- 1. Lawful permanent resident of the US may not be liable for failing to file FBAR disclosing bank accounts in foreign country for being treated as a resident under a US – Mexico tax treaty

E. Treaties May Protect Against FBAR Penalties

- **Aroeste v. US, 132 AFTR2d 2023 – 6577 (DC CA, 114/20/2023).** The taxpayer was born in Mexico and live there all his life. He worked in Mexico until he retired in 2012. The taxpayers owned a condominium in Florida which they had used as a vacation home. No one lived in the vacation home on a full-time basis. The taxpayer always filed Mexican tax returns as a resident in Mexico. In 1984, the taxpayer applied for and received permanent residency status in the United States the green card. The status was never revoked. His wife became a naturalized US citizen in 2011 and she was a citizen during the tax years at issue. The parties agreed that the wife was a citizen and thus a US person required to file a Report of Foreign Bank and Financial Accounts (FBAR) for the tax years at issue.

E. Treaties May Protect Against FBAR Penalties

- In 2012 and 13, the taxpayers had a financial interest or signature authority over five bank accounts in Mexico which exceeded in aggregate the balance of $10,000. With respect to their tax returns for 2012 and 2013, the taxpayers file an individual income tax return as married filing joint but did not submit Form 8833: Treaty Based Return Position Disclosure Under Section 6114 or 7701 (b) raising Article 4 of the US – Mexico income tax Convention. The taxpayer was previously advised to apply for and enter into the Offshore Voluntary Disclosure Program and the taxpayer did so but he did not file the FBAR for 2012 or 13. The taxpayer subsequently opted out of the disclosure program based upon legal advice regarding the US – Mexico Tax Treaty the IRS open examination and the taxpayer submitted an amended return indicating they were not required to file under the treaty. The taxpayer subsequently amended the return a second time to indicate married filing separate status with the wife would file the FBAR the husband would not.

E. Treaties May Protect Against FBAR Penalties

- The willful penalty was assessed for both 2012 and 2013. The taxpayers sued the United States seeking to recoup penalty payments. The issue is whether the husband was a US person who had a financial interest in or signature authority over a foreign financial account requiring the reporting if the foreign bank account exceeds $10,000 at any time during the calendar year. A US person includes a resident of the United States as well as resident aliens. It is undisputed the taxpayer obtained green card and it was never revoked. The taxpayer fit the definition of a resident alien who may be subject to the reporting requirements. The services position is that the forms required to be exempt were not filed timely and could not be accepted in an amended fashion.

E. Treaties May Protect Against FBAR Penalties

- The taxpayer asserts that the US-Mexico treaty prevails over late filing of the tax forms. Specifically, the taxpayer asserts that the failure to file Forms 1040 and are and Form 8833 deprives individuals of the trees benefits. The taxpayer argues that a taxpayer that fails to meets the requirements of the filing the forms should have a penalty equal to $1,000 for each failure not the FBAR penalty. The court determined that although the taxpayer did not give timely notice of his treaty position in the forms, the taxpayer did not waive the benefits of the treaty as asserted by the IRS. Hence the lower penalty provision would apply.

E. Treaties May Protect Against FBAR Penalties

- The court found that the taxpayer is a US person but ceased to be a lawful permanent resident of the United States because the taxpayer commenced to be treated as a resident of Mexico under the treaty. The taxpayer did not waive the benefits of the treaty and notified the secretary of the treasury of such treatment. The taxpayer is not under the treaty subject to the FBAR penalties under the treaty. The taxpayer is a US person but ceased to be treated as a lawful permanent resident of the United States because the taxpayer commenced to be treated as a resident of Mexico under the treaty and did not waive the benefits of the treaty. In addition, the government must refund the penalty assessed and abate. The taxpayer is charged with the thousand dollar penalty per failure to timely report the treaty position which would have been a total of $2,000.

F. Form 8938: Statement of Specified Foreign Financial Assets

- 1. Form 8938, “Statement of Specified Foreign Financial Assets,” is to be used by individuals to report an interest in one or more specified foreign financial assets under Section 6038D. The instructions reflect changes in the reporting requirements associated with the following:

- 2. Form 8938 disclosure statement requires the reporting of the maximum value of foreign assets during the tax year. The disclosure statement should also provide information regarding financial accounts, including the name and address of the foreign financial institution in which the account is maintained and the account number. In addition, the disclosure statement should also provide the name and address of foreign issuers of stocks or security and information that is as needed to identify the class of such stock or security. Also, foreign asset disclosure is required with respect to the issuance of foreign contracts, instruments or other interests.

F. Form 8938: Statement of Specified Foreign Financial Assets

- 3. Foreign real estate is not a reportable asset, this would include a personal residence or rental property. However, if the real property is held in a foreign entity the interest in the entity is a specified foreign financial asset that must be disclosed on Form 8938 if the total value of the financial assets falls within the threshold of reporting.

- 4. Tangible assets such as art, antiques, jewelry, cars and other collectibles directly held by the taxpayer or not specified foreign financial assets requiring disclosure. This would include precious metals. However. gold certificates issued by foreign person are a specified foreign financial asset would require disclosure.

F. Form 8938: Statement of Specified Foreign Financial Assets

- 5. A foreign pension plan or deferred compensation plan must be reported on Form 8938. In general, the value of the taxpayer's interest in the foreign plan is the fair market value of his or her beneficial interest on the last day of the year. However, if the taxpayer does not know nor has reason to know the fair market value of the plan's beneficial interest because such value is not readily accessible the maximum value is the value of cash property distributed to the taxpayer during the year. If there were no cash or property distributions from the form plan during the year and the taxpayer simply cannot readily determine the value, then it would not be reported.

- 6. The threshold for reporting on Form 8938 are shown below:

F. Form 8938: Statement of Specified Foreign Financial Assets

			If Total Value of Foreign Financial Assets Exceed
Not Living Abroad	On Last Day of the Year		At Any Time during the Year
Single and MFS	$50,000	or	$75,000
MFJ	$100,000	or	$150,000

F. Form 8938: Statement of Specified Foreign Financial Assets

			If Total Value of Foreign Financial Assets Exceed
Living Abroad	On Last Day of the Year		At Any Time during the Year
Single and MFS	$200,000	or	$300,000
MFJ	$400,000	or	$600,000

F. Form 8938: Statement of Specified Foreign Financial Assets

- 7. It should be noted that the form 8938 and the instructions have been converted from an annual revision to continuous use. Both the form instructions will be updated on an as needed basis.

- 8. The currency exchange rate converter generally is what is used for the conversion to US dollars. The link ishttps://fiscaldata.treasury.gov/currency-exchange-rates-converter/

VI. Cancellation of Debt (COD)

A. General Rule

- 1. Gross income includes income from the discharge of indebtedness. This applies equally to debts discharged by commercial lenders and those canceled by private lenders (See Section 61 (a) (12)).

- 2. In essence COD income can occur in any of the following circumstances:
  - Modification of a debt, as defined in Regs. Section 1.1001-3;
  - Issuance of equity in satisfaction of debt (see Sections 108(e)(8) and 108(e)(6));
  - Acquisition of outstanding debt at a discount by a party related to the debtor, as defined in Section 108(e)(4);
  - Issuance of a contingent value right or similar property right in satisfaction of debt;
  - Discharge of the debt occurring either within or outside a bankruptcy proceeding; and
  - An asset foreclosure or similar transaction satisfying the debt.

B. Forgiveness of Student Loan Debt

- 1. In a bankruptcy procedure forgiveness or discharge of debt can occur if there is undue hardship. This is the case with respect to student loan debt.

Example

- **In re Carney Bktcy Ct MA 131AFTR2d 2023 – 502.** The taxpayer claimed discharge of her student loan debt was denied because of her failure to prove undue hardship. The taxpayer argued that she would be suffering the same hardship in terms of a cancellation or forgiveness of debt income that will result if or when the debt was forgiven. Her alternative request for decoration that no income tax would arise from the discharge was also meaningless. She could not demonstrate that it was undue because it was mere speculative in nature at the time of the bankruptcy filing and she was seeking a chapter 13 reorganization

C. Insolvency can be a Reason for Exclusion from Gross Income

- **1. General Rule**. Section 108(a) defines the amount of insolvency subject to exclusion from gross income to be the amount of liabilities exceeding the fair market value of assets. The burden to substantiate insolvency rests with the taxpayer.

Examples

- **Henry v. Comm., TC Memo 2024 – 79**. Taxpayers cancellation of debt income exclusion was rejected by the IRS. Taxpayer maintained that he was insolvent when debts were canceled. Taxpayer acknowledged he received income from cancellation of debt and admitted he provided no information concerning his claim of insolvency. He asked at the Tax Court case to provide additional information of his insolvency. The income recognition was not included in the IRS notice to him of additional liability. As such the service bears the responsibility to demonstrate the taxpayer was in fact solvent. Since the IRS was late the insolvency position of the taxpayer stood.

Examples

- **Patacsil v. Comm., TC Memo 2023 – 8.** Married couple attempted to exclude cancellation of debt income for the year that the lender discharged a loan that the taxpayers claimed they were entitled to an exclusion of income based on insolvency. The taxpayers offered no evidence that their assets including were less than their liabilities. The inclusion or reference of a potential adverse adjustment in obtaining an employment lawsuit as a contingency does not establish insolvency.

- **Ahaiwe v. Comm., TC Summary 2023-7.** The taxpayer claimed an exclusion from income for canceled debt related to a credit card arguing he was insolvent at the time the debt was canceled. In support of his position, the taxpayer relied upon in insolvency worksheet he created but this did not meet the requirement of the worksheet necessary for substantiation purposes. The worksheet nor testimony established how the assets were valued at the balances of liabilities were not able to be confirmed by independent evidence.

C. Insolvency can be a Reason for Exclusion from Gross Income

- 2. The insolvency worksheet and supporting documentation surgery required to have the exclusion from gross income accepted.

Example

- **White v. Comm., TC Memo 2023 – 77.** The taxpayer was entitled to take advantage of the insolvency exception to exclude from gross income cancellation of debt income received in connection with the discharge of the business loan. The taxpayer attached worksheets at the time of the filing of the return showing that the debt had exceeded her assets and that she was insolvent at the time the business loan was discharged. The IRS argued that the loan was in association equity and not debt. In the event the court deemed it debt, the IRS argued that an acceleration of payment is not to be construed as associated with a bona fide debt arrangement. In this particular case, the debt was associate with real property and was part of a landlord-tenant situation. The landlord did not pursue litigation for the outstanding liabilities that does not preclude the arrangement from not meeting the definition of a bona fide debtor creditor arrangement. Even though the lessor did not sue the taxpayer or take other action other than eviction this does not mean that the debt was not otherwise bona fide debtor-creditor arrangement

C. Insolvency can be a Reason for Exclusion from Gross Income

- **3. Define Benefit Pension Plans**. The Service has announced in action on decision that it will not acquiesce to the decision in the Schiener case (TC Memo 2017 – 32). In that case, the Tax Court held an interest in a defined benefit pension plan is not an asset for purposes of applying the insolvency exclusion under Section 108.

- **4. Related Party Debt**. In determining insolvency of the taxpayer related party debt is not part of the determination of insolvency. Advances between related entities must establish a bona fide debtor creditor relationship to be successful as a bad debt deduction.

D. Capital Gain v COD on Real Property Sales. – Parker v Comm., TC Memo 2023 – 104.

- 1. COD income exists if a COD is not part of a sale or exchange of real property that is nonrecourse in nature.

Example

- Exterra Realty Partners, LLC wasn't an S corporation involved in real estate development. Mr. Parker was a 100% shareholder of the LLC and the CEO. Exterra was the sole member of PLF – XIII, LLC and PLF – XIV, LLC (PLF entities). These entities were disregarded entities. PLF – XIII was the sole member of Montevina Phase I, LLC, and PLF – XIV, LLC was the sole member of Montevina Phase II, LLC (Montevina) which were also disregarded entities. The Exterra entities, through the Montevina entities, purchased several acres of real property with loans that were obtained from an unrelated third-party lender. The Exterra entities contributed 1.5 million to Montevina entities for phase 1 and phase 2 development. In addition, Mr. Parker personally signs a guarantee for payment of all the loans. Several of these loans were nonrecourse. A couple of loans were secured by a pledge of the PLF's membership interest in the Montevina entities. Approximately six months after the purchase and the loans the Exterra entities agreed to sell the property to unrelated third-party purchasers. Likewise, the PLF entities agreed to sell their soul membership interest as well.

Example

- The buyers as part of the sale agreed to assume Mr. Parker's personal guarantee obligations and appropriate consent and release agreements were executed. The unrelated third-party lender agreed to cancel the unpaid balance of several of the Mezzanine loans. The language indicated that the cancellation was in connection with the proposed sale of all interest. The amount realized from the sale was over $40.5 million in the amount of debt canceled in association with the sale was approximately $12.7 million. Exterra filed its 1120S and reported gross receipts of $53.2 million consisting of the debt assumed by the buyer of the real property and the cancellation of the loans. An amended return was subsequently filed and Form 982: reduction of Tax Attributes due to Discharge of Indebtedness was attached. It resulted in a reduction in gross receipts of approximately $2.7 million in association with Exterra being insolvent to that amount. One loan that was forgiven by the third party was not included on the K-1.

Example

- The petitioner reported the 2.7 million as capital gains. The IRS disputed. The court indicated that if nonrecourse debt relief is conditioned upon a sale or exchange of property the amount of debt relief is included in the amount realized and is not cancellation of debt income. Also, the amount realized includes the amount of liabilities from which the transferor is discharged as a result of a sale or disposition. The service was taking the position that two of the loans that were eventually canceled were deep-handed upon the sale of the property. Those loans were nonrecourse and are includable in income as an amount realized on the sale of the property and are thus capital gain treatment.

E. Cancellation of Debt and Disregarded Entity

- 1. What is considered a discharge of debt in association with the disregarded entity.

Example

- **Jacobowitz v. Comm., TC Memo 2023 – 107.** The taxpayer had an LLC in which he was the sole member. The LLC, through the taxpayer, executed a promissory note and security agreement for a business line of credit with the bank. Default occurred. The taxpayer claimed the cancellation of debt income should not be attributable to him personally but to the LLC. The taxpayer never filed form 8832 electing to be treated as a corporation. For all purposes, he was treated as a disregarded entity. Cancellation of debt with respect to a disregarded entity is attributable to the individual taxpayer. In addition, the taxpayer failed to show the debt was discharged before the year at issue. The taxpayer also attempted to treat the cancellation of debt as capital gains claiming that as an LLC the bank never agreed that the LLC would surrender in any property in association with the line of credit and that the interest accrued was not associated with ordinary and necessary expenses of the business.

A. Compensation for Injury or Sickness and Punitive Damages – Section 104

- 1. Generally, compensation for personal injuries and sickness is excludable from gross income. The following are generally excludable:
- a. Amounts received under Workmen's Compensation
- b. Amount of damages received (other than punitive damages) on account of a personal physical injury or physical sickness. The exception excludes only physical injuries but not emotional distress because of age, race, gender, or disability, libel, slander and other nonphysical wrongs.

Example

- **Roma v. Comm., TC Memo 2023 – 142**. Formerly married couple received settlement from former landlord in connection with housing discrimination suit. The settlement agreement showed the payments were made primarily in return for the taxpayer’s timely vacating the apartment and not on account of personal injuries or sickness. Taxpayers claim the payments were made at least in part to settle various legal actions they brought against the landlord including future claims that man had. That argument was not persuasive in that the taxpayers argued emotional distress in association with leaving and not demonstrating any direct physical injuries or sickness.

A. Compensation for Injury or Sickness and Punitive Damages – Section 104

- c. Amounts received for accident or health insurance for personal injuries or sickness

- d. Amounts received as a pension, annuity for personal injuries or sickness resulting from active service in the Armed forces, public health service for foreign service.

- e. Amounts received as disability income attributable injuries occurred as a direct result of a terrorist or military action.

A. Compensation for Injury or Sickness and Punitive Damages – Section 104

- 2. Often several amounts received by compromise, mediation, arbitration or judgment are includable in gross income. The item that the settlement replaces must be considered. The following are generally includable as ordinary income:
- a. Interest on any award.
- b. Compensation for lost wages or lost profits.
- c. Damages for patent or copyright infringement, breach of contract, tortious interference with a business operation.

A. Compensation for Injury or Sickness and Punitive Damages – Section 104

- d. Backpay and damages for emotional distress under Title VII the Civil Rights Act of 1964.
- e. Attorney's fees and costs where the online recovery is included in gross income.
- f. Attorney's fees and costs way to wasn't going awards where the online recovery is included in gross income.

A. Compensation for Injury or Sickness and Punitive Damages – Section 104

- **3. IR 2023 – 81**. The IRS posted FAQs on its website that address the income tax consequences of state compensation payments received by victims of forced, involuntary all coerced sterilization. Under the FAQ, some states compensate victims under state programs. These compensations are pursuant to state legislation. In general, the FAQ states the compensation payments for four sterilization are excluded from gross income because the payments are compensatory damages for physical injuries.

- 4. Amounts received by the employee through an accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts are attributable to contributions by the employer which were not includable in the gross income of the employee or are paid by the employer. (See Section 105 (a))

A. Compensation for Injury or Sickness and Punitive Damages – Section 104

- **5. Workmen's Compensation**

- a. Service-connected disabilities generally excludable from gross income.

Examples

- **Tuma. Se. v. Comm., TC Memo 2024 – 71.** The IRS determined that the taxpayers railroad benefits and Social Security benefits received in the year at issue are not amounts that are associated with a disability excluded under Section 104. Merely making a claim that they are assessed with disability is not enough.

- **Scott v. Comm., TC Memo 2024 – 27.** The taxpayer received civil service retirement disability payments that were determined to be includable in the taxpayer’s gross income because the payments were not attributable to an injury or illness sustained through the husband’s active service in the arms forces. The exclusion of the payments under Section 104 does not apply. The taxpayer excluded the amounts on the federal return contending that the payments did not constitute taxable income. There was no evidence to suggest that the payments at issue were attributable to injury or illness sustained through the husband’s active service in the Armed Forces.

Examples

- **b. IRS Letter Ruling 202416001**. Section 130 Qualified Assignment of Liability. Section 130 provides an amounts received for agreeing to a qualified assignment which is an assignment of the liability to make periodic payment as damages or as compensation under Workmen's Compensation act or an account of a personal injury or sickness, are excludable from income to the extent the amounts did not exceed the arrogant cost of the qualified funding asset. The exclusion is associated with the process of assigning settlements to third parties who in turn paid the personal injury claimants a steady income stream over a timeline as opposed to a lump sum payment. The letter ruling provides a favorable interpretation of these structured settlement agreements allowing continued use of indexed annuities as a favorable payment treatment to claimants. The service in the letter ruling indicated that the periodic payments are fixed and determinable as required and that the contract will not fail to be a qualified funding asset despite the value increasing over time in the stock market.

A. Compensation for Injury or Sickness and Punitive Damages – Section 104

- **6. Employment Discrimination**. Rewards for employment discrimination or settlements do not fall within the section 104 exclusionary requirements.

Examples

- **Estate of Finnegan v. Comm., TC Memo 2024 – 42**. Several taxpayers were not entitled exclude settlement payments they received from their gross income. The taxpayers had entered into settlement agreements in a case related to their claims against defendants employed by the state of Indiana. In the settlement agreements, the taxpayers agreed to execute written documentation fully release the defendants from liability. The taxpayers urge the Tax Court to find the damage awards to the taxpayers were for posttraumatic stress disorder of a physical nature to the brain. However, the settlements made no such reference to posttraumatic stress disorder. On that basis the amounts were not deemed to be of a physical nature warranty exclusion under Section 104. Furthermore, the taxpayer's original lawsuit never asserted of physical claim against the state or the defendants. Rather, constitutional violations were asserted. The jury awarded the taxpayers compensatory damages as a result of the lawsuit for each of the constitutional violations. As such the amounts were not excludable from gross income.

Examples

- **Mcghee v. Comm., TC Memo 2023-97**. Damage award which taxpayer received in connection with wrongful termination/discrimination suit were taxable to him in year received was upheld. IRS met its minimal evidentiary burden linking taxpayer to said income with his stipulation to receiving damages; and he didn't show that any exclusion applied.

VIII. Rental Property and PAL Rules

A. Section 469

- 1. Section 469 limits the taxpayer's ability to deduct the losses from businesses in which he or she does not materially participate, and this limitation also applies to rental activities. The passive activity loss rules apply at the individual level and extend beyond tax shelters to businesses reported on Schedule C, D, F and flow through entities such as partnerships, LLCs, S Corp. and trusts.

- 2. A passive activity loss is defined as the excess of the aggregate losses from all passive activities for the taxable year over the aggregate income from all passive activities for that year. (See Section 469(d)(1))

- 3. A passive activity is any trade or business in which the taxpayer does not materially participate. § 469(c)(1). A taxpayer is treated as materially participating in an activity only if his or her involvement in the operations of the activity is regular, continuous, and substantial. (See Section 469(h)(1))

A. Section 469

- 4. In essence, losses and credits from passive activities are deductible to the extent they exceed income from all activities. In other words, they are deductible as losses to the extent of income.

- 5. There have always been two primary exceptions to this rule. The exceptions are associated with the status of being a real estate professional and secondly, the ability to deduct up to $25,000 of rental losses from actively managed real estate.

A. Section 469

- 6. The rule remains that any passive activity loss not currently deductible is suspended and becomes deductible in a subsequent year which the taxpayer either has net passive activity income or completely disposes of the passive activity property to an unrelated party.

- 7. Generally, any rental activity is per se a passive activity (See Section 469 (c) (2)). It is the taxpayer burden to overcome this by demonstrating material participation or the taxpayer is a real estate professional.

- 8. The regulation list exceptions to the definition. Specifically, an activity involving the use of property is not a rental activity for a taxable year if:

A. Section 469

- The average period of customer use for the property is 7 days or less;
- The average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property connection with making the property available for use by customer;
- Extraordinary personal services are provided by on behalf of the owner of the property connection with making such property available for use by customers;
- The rental of such properties treated as incidental to a non-rental act the taxpayer; the taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or
- The provision of the property for use in an activity conducted by a partnership, S corporation or joint venture in which the taxpayer owns an interest is not a rental activity.

Example

- **Rogerson v. Comm., 132 AFTR 2d 2023 – 5382**. The Tax Court determined that the taxpayers yacht related activity where the yachts were intended to be chartered was a rental activity under Section 469 court. The court noted the term passive activity includes rental activities.

- **Cardulla v. Comm., TC Memo 2023 – 89.** The taxpayer reported expenses exceeding rental income on 6 properties he owns. 4 of the properties were vacant land and one was an uninhabitable house due to earthquake damage. There was one with there was actual rental income of a legitimate nature. There was a lack of substantiation for the deductions and more importantly the taxpayer was advised cannot take depreciation or land.

A. Section 469

- 9. Section 280A – Disallowance of Certain Expenses in Connection with Business Use of home, rental, vacation homes, etc.

- a. Except as otherwise provided, in the case of a taxpayer who is an individual or an S corporation, no deduction shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence. This limitation shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business or with his income-producing activity.

A. Section 469

- b. In general, Section 280A provides that where a dwelling unit is used by a taxpayer as a residence, the taxpayer cannot claim a net rental loss.

- c. In such cases, deductions attributed to rental use are limited to the excess of gross rental income over the portion of the expenses otherwise allowable (such as mortgage interest and taxes which are allowable without regard to their connection to a business or investment) that are attributable to the rental activity. If the property is not used as a personal residence, all of the rental related expenses, subject to the passive activity and at-risk rules, are deductible.

A. Section 469

- d. More specifically, Section 162 (a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. Section 212(1) and Section 212(2) allow a deduction for ordinary and necessary expenses paid or incurred in connection with an activity engaged in for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

- e. Section 280A(d)(1) provides that a taxpayer (also known as a host) does not have to pay tax on income they earn from actually renting a unit for fewer than 15 days during the year if they also use the unit themselves as a residence.

A. Section 469

- f. Taxpayers or hosts are considered to use the unit as a residence if they use it for personal purposes during the tax year for more than the greater of:
  - 14 days or
  - 10% of the total days during the year they rent it to others at a fair rental value.

- g. A unit can be a room or an entire residence as the case may be.

A. Section 469

- h. A unit is not rented at fair rental value for any day it is used for personal purposes, which include use for any part of a day by the taxpayer, another person who holds an interest in the unit, or a family member of the taxpayer or other person with an interest in the unit.

- i. Personal use can include, but is not limited to, the property being used by the owner for personal purposes, any other person who uses the property for personal purposes if that person owns part of the property, family members of the owner unless rented for use, anyone who pays less than fair rental value and any agreement that allows owner to use the property for other than rental purposes.

A. Section 469

- j. Personal use does not include days where the owner works substantially full time repairing or maintaining the property, even if family members simultaneously used the property for recreational purposes.

- k. Personal use does not include days with the owner use the property as a primary residence before or after reading it or offering it for rent so long as the property was rented or the attempt to have it rented occurred for at least 12 consecutive months or a period of less than 12 months if the property was sold exchange at the end of the tax year.

Examples

- **Sinopoli v. Comm., TC Memo 2023-105**. The taxpayers were entitled to take deductions on their personal returns for rent expenses which corp. paid for use of The taxpayers' homes for business meetings in their residences above amounts IRS allowed. While The taxpayers failed to present any written documentation showing that all claimed meetings occurred during years at issue, they did establish one meeting per month for stated months in 2 of 3 years at issue, as the IRS had already allowed. They also established with their testimony that some meetings occurred during the remaining year, and were accordingly entitled to rent deductions for 12 meetings for that year. However, the taxpayers failed to establish the reasonableness of rent; rather, it appeared that the taxpayers adopted tax savings scheme to distribute corp.'s earnings to themselves through purported rent payments, claim rent deductions, and exclude rent from their gross income.

Examples

- **Conrad v, Comm., TC Memo 2023 – 100**. The taxpayers were the majority owners of an S corporation. The corporation paid the taxpayer for management services and accounting services. The payments were as if the taxpayers were independent contractors. This was never challenged or disputed by the IRS. Each of the taxpayers claimed a deduction for business use of their home. In the case of the husband, the IRS found that the office home was not used exclusively as the principal place of business. The corporation paid rent to the taxpayers for the office space. The rent was reported on Schedule E and expenses including taxes and interest were offset against it. The taxpayers admitted that often the office was used for personal purposes particularly when family members arrived. As such, the deductible expenses were limited to the rental income.

A. Section 469

- 10. While the taxpayers who rent out a unit for less than 15 days a year do not have to recognize income from the rental, they also cannot deduct expenses incurred in renting out the unit.

- 11. If clients rent their home or other unit for 15 days or more during the year, the taxpayer will need to report this activity when filing their individual income tax return unless the activity is operated as a partnership, S corporation, or other entity and reported on that entity's return, either on a Schedule C: Profit or Loss From Business, as trade or business income subject to self-employment tax, or on Schedule E: Supplemental Income and Loss, as rental income, not subject to self-employment tax but possibly subject to net investment income tax.

- 12. Recharacterization of Rental Income to nontaxable repayment of Loan

Example

- **Henry v. Comm., TC Memo 2024 – 79**. Taxpayer claim to recharacterize rental income reported from certain properties as nontaxable. Specifically as a repayment of an alleged loan to investors on properties purchased. There were no loan documents nor deeds to corroborate the taxpayers claim.

B. Material Participation

- 1. An individual is treated as participating “materially” for the taxable year if the individual's participation meets one of the participation tests listed in Reg. Sec. 1.469-5T(a)(1)-(7).

B. Material Participation

- The individual participates in the activity for more than 500 hours during such year;
- The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
- The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

B. Material Participation

- The activity is a significant participation activity (for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
- The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
- The activity is a personal service activity and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
- Based on all of the facts and circumstances the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Example

- **Lin v. Comm., TC Memo 2023 – 37.** A married couple was not entitled to deduct rental activity losses during the year they rented the basement in their three-story home to a friend at a below fair rental price. The taxpayers claim there were $30,000 of losses that yielded only $3000 of income. They claim the losses were comprised of maintenance, repairs, legal fees, HOA fees, and depreciation. There was no allocation provided. Regarding the HOA fees, they are not deductible as well as the depreciation because they did not own the house. The taxpayer ran an aerospace business activity through various entities and was also a boat enthusiast with yachts that he intended to charter. The Tax Court previously indicated the taxpayer materially participated in his aircraft activities. But he was prevented from applying losses from rental activities to offset the active income he received. The court determined that his yacht chartering activities rose to the level of rental property. The court indicated that the taxpayers participation in an activity is material if the involvement in the operations is regular, continuous and substantial. (Section 469 (h) (1)).

B. Material Participation

- 2. Section 469 (h) (1) states that an activity is material if the taxpayer is involved in the operations on a regular, continuous and substantial basis.

Example

- **Rogerson v. Comm., 132 AFTR2d 2023 – 6624 (CA 9).** The taxpayer ran an aerospace business activity through various entities and was also a boat enthusiast with yachts that he intended to charter. The Tax Court previously indicated the taxpayer materially participated in his aircraft activities. But he was prevented from applying losses from rental activities to offset the active income he received. The court determined that his yacht chartering activities rose to the level of rental property. The court indicated that the taxpayers participation in an activity is material if the involvement in the operations is regular, continuous and substantial. (Section 469 (h) (1) on appeal, the taxpayer attempted to argue that his aerospace business was not active in nature because it required little of his time to run the business.

Example

- Originally, the Tax Court rejected the taxpayer’s argument stating that the taxpayer’s ability to respond to detailed inquiry so quickly shows he had a detailed knowledge level of every aspect of the business. The appeals court noted that Section 469 (h) does not impose a minimum hours requirement to find the taxpayers participation is material. Rather, the standard is materiality is based on regular, continuous and substantial in nature. The court determined that the activities of the charter evinces fell within the definition of short-term rental.

C. Real Estate Professionals

- 1. A taxpayer's rental real estate activities in which he or she materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. This means that real estate investors who qualify are permitted to deduct their rental real estate losses against other income sources (e.g., commissions, wages, etc.) (See Sec.469(c)(7)). The eligibility requirements include the following:

- a. The taxpayer owns an interest in the real property. (See (Reg. Sec.1.469–9(b)(6)).

C. Real Estate Professionals

- b. More than 50% of the individual's personal services during the tax year must be performed in real property trades or businesses in which the individual materially participates, and
- c. The individual must perform more than 750 hours of service in those same trades or businesses.
- d. The total time spent in any combination real estate related activities is used to determine if the 50% and the 750-hour tests are met.
- e. Real property trade or business means “any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage or trade or business” (See Section 469(c)(7)(C)).

C. Real Estate Professionals

- **2. Aggregation of Rental Real Estate When a Real Estate Professional**

- a. Each interest of the taxpayer in rental real estate is to be considered as a separate activity, but a taxpayer **may elect** to treat all interests in real estate, including real estate held through pass-through entities, as one activity (See Section 469(c)(7)(A)).

C. Real Estate Professionals

- b. The aggregation option permits the investor to meet the material participation test after cumulatively materially participating in all the real estate rentals. Without the aggregation option, the investor would be required to materially participate in each activity, making it more difficult to get around the passive loss limitations.

- c. The election to treat all interests in rental real estate as a single rental real estate activity is binding for all future years unless there is a material change in a taxpayer's facts and circumstances.

C. Real Estate Professionals

- d. The taxpayer makes the election by filing a statement with his or her original income tax return. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to Section 469(c)(7)(A) (See Reg. Sec.1.469-9(g)).

- e. Taxpayers that are real estate professionals may make a late election to group rental activities if they represent on a statement, filed under penalty of perjury that they meet the following requirements:

C. Real Estate Professionals

- The only reason that the election was not made timely was not because the taxpayer did not file the statement with his or her return the first year, they became a real estate professional.

- The taxpayer fought all required federal tax return consistent with the requested grouping for all years including and following the year the taxpayer intended the grouping to be effective.

- The taxpayer timely filed each return that would've been affected by the election if the grouping has been timely filed and the tax bill we treated as having timely filed the return was filed within six months after the due date including extensions.

- The taxpayer had reasonable cause the failure to meet the requirements to file timely.

C. Real Estate Professionals

- **3. Substantiation**

- a. With respect to the evidence that may be used to establish hours of participation, the extent of an individual's participation in an activity may be established by any reasonable means.

- b. Time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries (See Reg. Sec. 1.469-5T(f)(4)).

Example

- **Gossain v. Comm., TC Memo 2024 – 97**. Taxpayers rented out property and provided during IRS audit activity logs stating that husband worked on the property 751 hours for 2009, 751 hours for 2010, 757 hours for 2011, 753 hours for 2014, and 752 hours for 2016. A second rental property was purchased in 2016. The taxpayer had a full-time job working at least 40 hours a week. Taxpayer argues he materially participate in the rental properties for the timeframe stated herein. The court looked at whether the taxpayer was a real estate professional. The logs were not contemporaneous. The hours in question include personal work on the property when it was not rented.

D. Section 274 Substantiation Requirements - Rule

- 1. Section 274(d) imposes stricter substantiation requirements for deductions claimed for, among others, expenses of travel (including meals and lodging while away from home) and listed property.
- 2. No such deduction is allowed unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating his or her own statement the amount, time and place, and business purpose for each expenditure.
- 3. Adequate records for this purpose include an account book, log, or similar record and documentary evidence that together are sufficient to establish each element of the expenditure.

D. Section 274 Substantiation Requirements - Rule

- 4. To be adequate, records must be prepared or maintained in such a manner that each recording of an element of expenditure is made at or near the time of the expenditure or use.

- 5. It should be noted however that if a log is not contemporaneous other sufficient credible evidence can be considered. This is often the case when the taxpayers forced to reconstruct efforts as a result of a casualty event. Other sufficient evidence can include the taxpayer's own statements as well as oral testimony if the testimony can evolve the elements of cost, amount, time, place, and date of the expenditure.

D. Section 274 Substantiation Requirements - Rule

- 6. Temporary Treasury Regulation § 1.274-5T(b)(2)(ii) defines the term "time" as "dates of departure and return for each trip away from home, and number of days away from home spent on business," and subdivision (iii) defines the term "place" as "destinations or locality of travel, described by name of city or town or other similar designation." For certain property, such as an automobile, the taxpayer must also establish the amount of business use "based on the appropriate measure (i.e., mileage for automobiles and the total use of the listed property for the taxable period." See subpara. (6)(i)(B).

E. Reporting Matters

- **A. Schedule E vs. Schedule C**. In general, taxpayers who rent buildings, rooms, homes or apartments in which they provide basic services such as heat, light, trash collection and cleaning of public areas will report income and expenses on Schedule E.

- 2. However, Schedule Sees use when the taxpayer or host provides substantial services in connection with the property or rental that is associated with a trade or business or if they are operating as a real estate dealer.

- a. Substantial services is not defined and that is part of the problem.

- b. It appears that substantial services are for the primary convenience of the tenant. This could include regular cleaning or maid service. It needs to be emphasized this is a subjective test.

E. Reporting Matters

- **3. Apportionment of Deductions**
- a. If there is any personal use of a dwelling unit or vacation home that taxpayers rent out, they must separate expenses for rental use versus personal use.
- b. Generally, if the entire unit or home is being rented, the portion of the total expenses treated as rental expenses is determined by multiplying the total expenses by a fraction, with the denominator being the number of days the dwelling unit is used during the year and the numerator being the total number of days it is rented at fair value.
- c. Allowable rental expenses are deducted on Schedule E or C, and allowable personal expenses are deducted on Schedule A: Itemized Deductions, if the taxpayer itemizes (e.g., mortgage interest).

F. Renting A Room out of a Residence

- 1. Taxpayers who rent out part of a residential unit and continue to occupy or have personal use of the remaining portion must first divide expenses attributable to both rental and personal use.

- a. This would include mortgage interest, utilities on the entire property. The allocation must be between the portion of the residential unit used exclusively for rental purposes and the portion of it used for personal purposes as though they were separate pieces of property.

F. Renting A Room out of a Residence

- 2. The allocation is generally one that is considered reasonable in nature. To that extent it can be one of two types:

- a. Allocation based on square footage of the rental unit versus the entire residential property.

- b. Allocation based upon the rental unit versus the total number of rental units in the residence. They can use any reasonable method for dividing the expense.

F. Renting A Room out of a Residence

- 3. If the rental portion of the dwelling unit was used for less than the entire year, the deductible amount of the expenses for the rental portion of the dwelling unit is then determined by multiplying the total expenses for the rental portion of the property by a fraction, with the denominator being the number of days the portion of the dwelling unit is used during the tax year and the numerator being the total number of days the portion of the dwelling unit is rented at fair value.

- a. In addressing the computation,, any day the portion of the unit is not rented is treated as a personal-use day.

F. Renting A Room out of a Residence

- 4. Taxpayers can deduct the expenses associated the rental portion on Schedule E. It should be noted that the Passive Loss Limitations and At Risk limitations may apply if a loss occurs. The taxpayer should be advised of these limitations in the tax preparer should examine IRS Publication 527: Residential Rental Property.

- 5. The expenses that are deductible for the personal- use portion of the property, such as home mortgage interest and real estate taxes, are taken on Schedule A as itemized deductions.

F. Renting A Room out of a Residence

- 6. Taxpayers do not have to divide the expenses between rental and personal use for the items that relate only to the rental portion, such as painting, repairs, or a second phone line. These expenses are deductible as rental expenses. They are also allowed to claim a depreciation deduction on furniture and equipment attributable to the rental property.

G. Self-Employment Tax Issues Regarding Rentals

- 1. Generally, rents from rental arrangements are not subject to self-employment tax.

- 2. Section 1402 (a) (1) provides an exclusion from such self-employment income for gross income that individuals other than real estate dealers earn from "rentals from real estate and from personal property leased with the real estate."

- 3. A real estate dealer is "an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales." (See Section 1221)

- 4. The regulations also provide that "an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer." The courts have traditionally used the following factors (Winthrop, Ada Belle v. Tomlinson, (CA-5) 69-2 USTC ¶9686, 417 F2d 905)):

G. Self-Employment Tax Issues Regarding Rentals

- The reason and purpose the property was acquired and/or disposed;
- The length of time the property was held;
- The number and frequency of sales, usually annually;
- The continuity of sales or sales-related activity over a period of time;
- Overall reluctance to sell the property;
- The substantiality of the gain obtained on the sale
- The extent to which the taxpayer or his or her agents engaged in sales activities by developing or improving the property, soliciting customers, or advertising;
- The substantiality of sales when compared

G. Self-Employment Tax Issues Regarding Rentals

- The desire to liquidate unexpectedly obtained land holdings

H. CCA 202151005- Income from Short-term Rental Includable in Self Employment Income

- 1. The Service recently in a CCA discussed 2 examples when income from short-term rentals is includable in self-employment income. Under Section 1402 (a)(1), net rental income generally is not included as income subject to self-employment tax unless the income is received by a real estate dealer or the rent includes substantial services provided to the occupant for the occupants convenience.

- 2. A rental activity is not a passive activity if the average period of customer use the property is 7 days or less in addition, rental activity is not passing if the taxpayer materially participates in the activity (Section 469)

Example 1

- Individual who is not real estate dealer has been renting a fully furnished vacation property via an online. The individual provides daily housekeeping services, access to Wi-Fi, a beach and recreation equipment for occupants during their stay and prepaid vouchers for ride share services between the property and nearby business. The customers used the property on average for 7 days. The activity is not considered a rental activity for purposes of the passive activity loss rules. The CCA notes that the taxpayer provided services for the occupants that are not clearly required to maintain the property in condition for occupancy and are of **such a substantial nature** that the compensation for those services constitutes a material portion of the rent. As such the net rental income is included in income subject to self-employment tax.

Example 1

- **Note**: The assumption is the activity is not a rental activity because of the seven day or less average requirement. Further, the assumption is that the taxpayer materially participates within the meaning of Section 469 (h) (1). As such the activity is not passive in nature. Thus, the net rental income is subject to self-employment tax because what the taxpayer provides is substantial services beyond what is required to maintain the space in a condition suitable for occupancy.

Example 2

- An individual who is not a real estate dealer has a business renting fully furnished rooms and bathrooms in their home via an online rental marketplace. Renters only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry area. The taxpayer cleans the room and bathroom in between each occupants stay. For the tax year at issue, the average period of customer use of the property 7 days and the taxpayer materially participates in the activity. The activity is not passive for purposes of the passive activity loss rules. Taxpayer's net income from renting of the living quarters is not income subject to self-employment tax because no services are rendered to the occupants. Taxpayer cleans and maintains the property so that it remains suitable for occupancy. The services are not furnished primarily for the occupants convenience.

Example 2

- **Note**: the net rental income is not subject to self-employment tax even though the taxpayer may materially participate in the activity which would make the activity active in nature. It is not subject to self-employment tax because the taxpayer is not providing substantial services beyond what is required to maintain the space in a suitable condition for occupancy.

I. Reg § 1.1402(a)-4. Rentals from Real Estate

- 1. Rentals from real estate and the deductions attributable thereto, unless the rentals are received by the taxpayer in the course of a trade or business as a real estate dealer are excluded from self-employment tax as a general rule.

- 2. Obviously, a taxpayer who holds real estate for investment or speculation and receives rentals is not a real estate dealer.

- 3. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded.

I. Reg § 1.1402(a)-4. Rentals from Real Estate

- 4. Under Regulation 1.1402 (c) – 4, payments or the use or occupancy of entire private residences or living quarters in duplex or multiple-housing units are generally rentals from real estate. Except in the case of real-estate dealers, such payments are excluded in determining net earnings from self-employment even though such payments are in part attributable to personal property furnished under the lease.

- 5. Likewise, payments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not constitute rentals from real estate; consequently, such payments are included in determining net earnings from self-employment.

I. Reg § 1.1402(a)-4. Rentals from Real Estate

- 6. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.
- 7. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant.

Example

- Bubba owns a building containing four apartments. During the tax year he receives $1400 from two of the apartments rented without services provided to the tenants. He receives $3600 from the other two apartments rented with services rendered to the occupants. His fixed expense for all four apartments totals $1200 during the taxable year. In addition, he has $500 of expenses attributed services rendered to the occupants of two of the apartments where they are paying the $3600 amount. There is net income subject to self-employment tax from the rental. The taxpayer would include $3600 received from the two apartments and the expenses of 1100. This consists of $500 attributable to the services of the higher expense tenets and one half of the $1200 for all of four apartments combined. The rental income from the first two apartments were no services are provided is excluded from income.

I. Reg § 1.1402(a)-4. Rentals from Real Estate

- **8. Substantial Service Dilemma**. The exclusion of rental activities from self-employment tax does not apply if substantial services are provided to the tenant or occupant. The determination of substantial services is a facts and circumstance examination.

- a. The Regulation states that Stan shall services provided by a landlord or homeowner to a tenant/occupant involves a level of service that exceeds those usually or customarily rendered in connection with the rental of rooms or other spaces of occupancy.

- b. In applying the above example there is no bright line test to determine substantial services. In examining the CAA the closest definition or test of substantial services is whether or not the occupant or tenant is receiving a **convenience or a benefit from the services provided.**

I. Reg § 1.1402(a)-4. Rentals from Real Estate

- 9. Despite the exposure for self-employment tax, the taxpayer if they provide substantial services and there is a loss the passive activity rules and at risk rules may place a limitation period. In the alternative, if the self-employment tax is not applicable the taxpayer may have some exposure under Section 14112 the net investment income tax.

- 10. The service has determined that if the taxpayer provide substantial services to an occupant/guest the income may need to be reported on Schedule C is the subject to self-employment tax. From a planning perspective, taxpayers may wish to consider alternatives such as moving the property into a S Corporation to mitigate FICA tax. Despite that movement, the taxpayer still would have to demonstrate material participation even in an S Corporation to obtain a loss deduction in the event that occurs.

I. Reg § 1.1402(a)-4. Rentals from Real Estate

- 11. To date there are no revenue rulings, revenue procedures, court cases that have addressed a definition of substantial services. This is going to be an issue going forward in the gig economy.

- 12. Obviously, and as previously stated, if the client does not provide substantial services then the net income from the rental would not be subject to self-employment tax and would be identified on Schedule E. It is still important to meet the 14 day or 10% test so that the Bible deductions can occur.

IX. Section 165 Losses

A. General Rule

- 1. Section 165(a) allows a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

- 2. The basis for determining the amount of the deduction for any loss shall be the adjusted basis for determining the loss from the sale or other disposition of the property. (See Section 160 5B)

- 3. In the case of an individual taxpayer the deduction shall be limited to losses incurred in a trade or business, losses incurred in a transaction entered into for profit, though not conductive the trade, or and except as otherwise provided, loss of property not connect with the trade or business or transactions entered into for profit if such losses arise from fire, storm, shipwreck or other casualty or from theft business.(See Section 165 (c).

- 4. Any theft loss arising from theft shall be treated as sustained or the taxable year in which the taxpayer discovers the loss

Examples

- **Giambrone v. Comm., TC Memo 2024 – 145**. The taxpayers had a successful mortgage finance business they decided to start a federally chartered savings and loan bank. Losses did occur from the get-go but the taxpayers had more capital to cover the increasing losses. Upon a regulator examination, the taxpayers were advised that they would be increase operating restrictions resulting in them seeking additional capital. They sought additional capital from an unrelated third party by selling 75% of the business to the unrelated third party causing the taxpayer's share of the business to be reduced substantially. The third-party they sought the additional capital from was involved in a fraud scheme and the thrift was subsequently shut down.

Examples

- The taxpayers claimed theft losses of 95% of the value of their investment in the thrift business on their tax returns. The taxpayer cited Rev. Proc 2029 – 20 that provided an optional safe harbor for taxpayers to experience losses in certain investment arrangements discovered to be criminally fraudulent. The court found that the safe harbor treatment must be elected on the taxpayers return in the year of discovery of the theft. This had not occurred. The brothers also claimed that they had suffered a theft of their controlling interest in the institution.

Examples

- It was determined that the third party was ordered to repay restitution and that should have been a factor in determining if the taxpayers had a reasonable prospect of recovery prior to taking the theft deductions on the return. The taxpayers were never named as victims with respect to the fraud scheme. The reasonable prospect of recovery had occurred in a subsequent timeframe.

A. General Rule

- 5. Decline in value and Theft Loss

Example

- **Pascucci v. Comm., TC Memo 2024 – 43.** The taxpayer was not entitled to a theft loss deduction or losses from the declining cash value of separate accounts for variable life insurance policies after unraveling of a high profile Ponzi scheme. The taxpayer never owned the assets in the state account at the time the theft occurred. Likewise, the taxpayer was not a qualified investor in the insurance policies and was not entitled to any theft deduction safe harbor.

X. Other Gross Income Recognition Matters

A. Gambling Winnings and Losses

- **1. Gambling income**. Gambling income isn't limited to in-person winnings at horse races, and casinos. It may also include winnings from playing online games and participating in television game shows. Gambling income includes both cash winnings and the fair market value of prizes, such as cars and trips.

- **2. Payors required to report income**. Anyone who pays out gambling winnings must issue the winner a Form W – 2 G: Certain Gambling Winnings when the taxpayer's winnings are:
  - $1,200 or more (not reduced by the wager) from a bingo game or slot machine,
  - $1,500 or more (reduced by the wager) from a keno game,
  - More than $5,000 (reduced by the wager or buy-in) from a poker tournament,
  - $600 or more and at least 300 times the amount of the wager (except winnings from bingo, slot machines, keno, and poker tournaments) reduced, at the option of the payer, by the wager, or
  - Subject to federal income tax withholding (either regular gambling withholding or backup withholding).

A. Gambling Winnings and Losses

- 3. A payer that withholds tax from a gambler's winnings should always file a Form W-2G with the IRS (and provide a copy to the winner) that shows how much the individual won and the amount of tax withheld.

- 4. Taxpayers who have gambling winnings must report all such income on Form 1040, U.S. Individual Income Tax Return, or Form 1040 – SR, U.S. Tax Return for Seniors. This includes amounts that are not reported on a Form W – 2 G.

- 5. Gambling winnings are reported on Schedule 1 (Form 1040).

A. Gambling Winnings and Losses

- 6. Generally, income tax is withheld from gambling winnings of more than $5,000 from a:
  - Sweepstakes,
  - Wagering pool,
  - Poker tournament,
  - Lottery, or
  - Any other wager if the proceeds are at least 300 times the amount of the bet.

A. Gambling Winnings and Losses

- 7. Usually, income tax is withheld at a flat 24% rate. Income tax is not usually withheld from gambling winnings from bingo, keno, and slot machines.

B. Gambling Losses

- 1. Gambling losses are an itemized deduction taken on Schedule A (Form 1040). Nonprofessional gamblers can't deduct gambling losses that exceed the gambling income reported on their return. Gambling losses can be claimed up the amount of gambling income as "Other Itemized Deductions" on Schedule A.

Examples

- **Kalk v. Comm., TC Memo 2024 – 82**. Taxpayer was entitled to deduct gambling losses up to the amount of her gambling winnings to the extent substantiated. The taxpayer substantiated losses with casino win loss statements.. The taxpayer did not obtain deductions for other years because of the lack of substantiation the signing in of a casino member card is not enough to substantiate deduction.. The court will allow a non-contemporaneous documentation to prove losses as well as bank statements.

B. Gambling Losses

- **Bright v. Comm., Tax Court Docket No. 10095 – 22 (5/4/23).** The taxpayer hired to prepare a report his gambling activity on Schedule C showing $240,895 of gross receipts in equal amount of expenses. The IRS determined that taxpayer was not a professional gambler and that his winnings should be reported as miscellaneous income and is losses should be a miscellaneous itemized deduction. Taxpayer did not know how the return preparer calculate his winnings on Schedule C a since he was unable to establish that his winnings were less than what he reported on return, the court agreed with the Service that the gambling winnings were $240,895. The taxpayer failed to establish gambling losses in the amount he reported on the return. Records did establish that he and losses of no less than $191,756.

C. Qualified Transportation Fringe Benefits

- 1. Prior to the implementation of Tax Cuts and Jobs Act, the value of qualified transportation fringe benefits provided by an employer to an employee was excluded from the employee's gross income subject to monthly limits.

- 2. Qualified transportation fringe benefits were defined as consisting of:
  - Commuter transportation in a commuter highway vehicle
  - Transit Passes
  - Qualified Parking
  - Qualified bicycle commuting reimbursement

C. Qualified Transportation Fringe Benefits

- Note: qualified bicycle commuting reimbursement is not an exclusion for tax years beginning after December 31, 2017 before January 1, 2026.

- 3. Employers may provide employee with one or more of these benefits at the same time. However, they must not exceed a monthly excludable limit. The excludable limit is exempt from withholdings and payment of employment taxes, is not reportable on the employee’s form W – 2 and thus is not includable in income.

C. Qualified Transportation Fringe Benefits

- 4. For 2024, an employee will be able to exclude up to $315 a month for qualified parking expenses, and up to $315 a month of the combined value of transit passes and transportation in a commuter highway vehicle. (See Rev. Proc. 2023-34)

- 5. For 2025, an employee will be able to exclude up to $325 a month for qualified parking expenses, and up to $325 a month of the combined value of transit passes and transportation in a commuter highway vehicle. (See Rev. Proc. 2024 – 40)

D. Crowdfunding Distributions – FS – 2024 – 28

- 1. The IRS on's website released a fact sheet reminding taxpayers that crowdfunding distributions may be includable in gross income of the person receiving them depending upon facts and circumstances.
- 2. In addition, the crowdfunding site or its payment processor may be required to report these distributions to the IRS on Form 1099 – K.
- 3. Crowdfunding involves funding a project by raising contributions of a large number of people typically through online websites. Often they are associated with a charitable cause that does not involve a recognize 501(c)(3).
- 4. The American Rescue Plan Act of 2021 clarifies that crowdfunding websites or their payment processors may not be required to file Form 1099 – K with the IRS or furniture to the persons whom the distributions are made if the payments are not made in exchange for goods or services.

D. Crowdfunding Distributions – FS – 2024 – 28

- 5. Loosely, the reporting threshold for Form 1099 – K were distributions to a person exceeding $20,000 from more than 200 transactions.

- 6. Notice 2023 – 10 and Notice 2023 – 74. For 2024, the IRS announced a plan threshold to be reduced to $5,000 as a phase in of the new 1099 – K reporting requirement.

- 7. The IRS also indicated that in some instances it may be possible to treat these distributions as gifts. The service acknowledged that some contributions may qualify as a gift if it is made as a result of the contributors detached and disinterested generosity.

E. Home Energy Rebates Not Includable in Gross Income – IRS Announcement 2024 – 19

- 1. Rebates paid at the time of sale under two home energy rebates programs that were created in the Inflation Reduction Act are not includable in the individual purchases gross income or cost basis.

- 2. The Inflation Reduction Act of 2022 appropriated money and authorized the Energy Department to administer to rebate programs under Sections 50121 and 50122, one for whole house retrofits and the other for high energy home electrification projects.

- 3. A rebate paid to or on behalf of a purchaser will be treated as a purchase price adjustment and is not includable in the purchases gross income under Section 61.

- 4. A rebate paid the time of sale is not includable in the purchases cost basis under Section 1012. By way of illustration, if the purchaser receives a $500 rebate at the time of sale of the property with the sales price of $600, the purchases cost basis in the property is $100.

E. Home Energy Rebates Not Includable in Gross Income – IRS Announcement 2024 – 19

- 5. The amount of rebate provided later constitutes an adjustment to basis under Section 1016. By way of illustration, if a purchaser spent $600 to buy eligible property but later receives a $500 rebate purchasers cost basis is reduced to $100 when the rebate was provided.

- 6. The pay or of the rebate is not required to file information return with the IRS or seek a statement to the purchaser to report the payments of a rebate to the purchaser.

- 7. Rebate payments made directly to a business taxpayer in connection with the business taxpayer sale of goods or services to a purchaser are not excluded from the taxpayer's gross income.

E. Home Energy Rebates Not Includable in Gross Income – IRS Announcement 2024 – 19

- 8. The rebates coordinate with Section 25 C credit that allows taxpayers receive a credit up to 30% of certain qualified expenditures that go toward energy efficient improvements to the home. The correct term is To $1200 with another $2000 For improvements include electric or natural gas heat pumps, electric or natural gas heat pump water heaters or biomass stoves or borders.

- 9. Taxpayers to receive rebates under the Department of Energy home energy rebate programs and who are also eligible for the credit must reduce the amount of the qualified expenditures used to calculate the credit by the amount of the rebate.

- 10. The taxpayer purchases an item or the item is eligible for both rebates and the Section 25 C credit, to determine the amount paid for the item, the tax premise allocate the rebates pro rata individually itemized expenditures as a share of the total project cost.

Example

- A taxpayer receives a $2,000 rebate for a whole house energy savings retrofit and allocates it proportionately, 60% to $3,000 in qualifying expenditures for a heat pump ($1,200 of the $2,000 rebate) and 40% to $2,000 in qualifying expenditures for insulation ($800 of the $2,000 rebate). The taxpayer may treat the amount paid or incurred for the heat pump as $1,800 ($3,000 less $1,200 allocated portion of the rebate) and the amount paid or incurred for the installation is $1,200 ($2,000 less the $800 allocated portion of the rebate)

F. Constructive Receipt from IRA is Gross Income

Example

- **Hubbard v. Comm., TC Memo 2024 – 16**. The taxpayer was liable for taxes with respect to a distribution from his IRA because he constructively received the income when he criminally forfeited his IRA. The Tax Court has ruled that when a taxpayer forfeits their IRA to the government due to a criminal conviction it is an involuntary distribution that is includable in income. The taxpayer argued that since the sales proceeds were paid directly to the government the taxpayer never had dominion or control over the funds and as such the constructive receipt doctrine does not apply. The taxpayer also argued he did not take any willful or voluntary act to distribute the IRA that was forfeited. The Tax Court concluded that they funds were not under his control but that the taxpayer constructively received the funds by having received the economic benefit through the satisfaction of his forfeiture liability to the government. Willful or purposeful cause is not part of the conversation in terms of determining tax liability.

G. State Relief Payments Excluded from Income – Notice 2023 – 56

- 1. The Notice describes the federal tax consequences of payment of estate tax refunds and certain state tax payments made individuals in 2023 and later years.

- 2. The notice provides that if an individual claims the standard deduction for a tax year in which the individual paid state income taxes that are refunded, the refund a subsequent year is not includable in the individual's gross income for federal tax purposes.

- 3. An individual who itemizes and deducts the amount of state income taxes paid however is required to include the state refund in gross income to the extent that the individual received a federal income tax benefit from the prior deduction of taxes.

G. State Relief Payments Excluded from Income – Notice 2023 – 56

- 4. Spillover payments which were made early in 2023 under 2022 programs covered by IR – 2023 – 23 remain excludable from gross income for individuals who did not receive a payment under the 2022 program.

- a. Taxpayers in Alaska, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Maine, New Jersey, New Mexico, New York, Oregon, Pennsylvania and Rhode Island don't need to report their state relief payments because the payments were made for the general welfare or were a form of disaster relief.

- b. For taxpayers in Illinois and New York, which issued multiple payments, one of the payments can be treated as a tax refund and the other payment can be treated as a disaster relief payment.

G. State Relief Payments Excluded from Income – Notice 2023 – 56

- c. Taxpayers in Georgia, Massachusetts, South Carolina and Virginia will need to meet certain requirements in order to exclude their state relief payments from income. These requirements are:
  - the payment was a refund of state taxes paid and
  - the taxpayer either claimed the standard deduction or itemized their deductions but did not receive a tax benefit from their state tax deduction.

- 5. State payments made under state program for the promotion of general welfare are not includable in the taxpayer's gross income. To qualify for the general welfare exclusion (Section 139) the payments must be made from a government fund, be for the promotion of general welfare (individual or family need) and not represent compensation for services.

H. Proposed Regulations would Exclude Tribal General Welfare Benefits from Income

- 1. The IRS has issued proposed regulations under Our e.g. – 106851 – 21 which layout the requirements for determining whether benefits provided by an Indian Tribunal Government qualify as Tribunal general welfare benefits and thus will be excludable from gross income.

- 2. Section 139 E excludes the value of certain tribal benefits from gross income. Specifically, gross income does not include the value of any Indian general welfare benefits which is considered a payment made for services provided to or on behalf of any member of an Indian tribe or their spouse or dependent pursuant to an Indian tribal government program.

H. Proposed Regulations would Exclude Tribal General Welfare Benefits from Income

- 3. Proposed regulations would provide that gross income of a tribunal program participant does not include the value of any Tribunal general welfare benefit provided by the Indian tribal government program.

- 4. The proposed rags once finalized would apply to the tax years of the tribal program the beginning on or after the day they are published in the Federal Register is final.

SECTION III:

ADJUSTMENTS TO GROSS INCOME

I. Health Savings Accounts

A. 2024 Figures – Rev. Proc 2023-23

- 1. The 2024 maximum contribution to an HSA that may be made for calendar 2024 by an individual with self-only coverage will be $4,150, a $300 increase from 2023. For an individual with family coverage, the maximum contribution will be $8,300, which is $550 higher than the current limit of $7,750.

- 2. The $1,000 "catch-up" additional contribution that may be made by individuals who are age 55 or older before the end of the tax year is unchanged

- 3. Likewise, the HDHP must have an annual deductible of at least $1,600 for self-only coverage ($100 higher than for 2023) or $3,200 for family coverage (a $200 increase).

- 4. The, annual out-of-pocket expenses, including deductibles, co-payments, and other amounts exclusive of premiums may not be more than $8,050 for self-only coverage or $16,100 for family coverage — increases, respectively, of $550 and $1,100.

B. 2025 Figures – Rev. Proc 2024-25

- 1. The 2025 maximum contribution to an HSA that may be made for calendar 2025 by an individual with self-only coverage will be $4,300, a $150 increase from 2024. For an individual with family coverage, the maximum contribution will be $8,550, which is $250 higher than the current limit.

- 2. The $1,000 "catch-up" additional contribution that may be made by individuals who are age 55 or older before the end of the tax year is unchanged

B. 2025 Figures – Rev. Proc 2024-25

- 3. Likewise, the HDHP must have an annual deductible of at least $1,650 for self-only coverage ($50 higher than for 2024) or $3,300 for family coverage (a $200 increase).

- 4. The, annual out-of-pocket expenses, including deductibles, co-payments, and other amounts exclusive of premiums may not be more than $8,300 for self-only coverage or $16,600 for family coverage.

C. Notice 2024 – 75: Expanded List of Preventive Care Services for High Deductible Health Plans

- 1. To be eligible to contribute to a health savings account, an individual must be covered by a high-deductible health plan (HDHP).
- 2. The HDHP may not provide coverage for health care below the statutorily determined high deductible amount; however, expenses paid for preventive care can be paid by the HDHP below the deductible.

C. Notice 2024 – 75: Expanded List of Preventive Care Services for High Deductible Health Plans

- 3. Notice 2024-75 expands the list of preventive care benefits that can be provided by a HDHP to include over-the-counter oral contraceptives and male condoms.

- 4. The Notice clarifies when breast cancer screening, glucose monitors for individuals diagnosed with diabetes, and certain insulin products are treated as preventive care benefits.

II. Medical Savings Accounts

A. 2024 – Rev. Proc. 2023 – 34; IR 2023 – 208

- **1. Self-only coverage**. For taxable years beginning in 2024, the term “ high deductible health plan” as means, for self-only coverage, a health plan that has an annual deductible that is not less than $2,800 and not more than $4,150, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $5,550.

- **2. Family coverage**. For taxable years beginning in 2024, the term “ high deductible health plan” means, for family coverage, a health plan that has an annual deductible that is not less than $5,550 and not more than $8,350, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $10,200.

B. 2025 – Rev. Proc. 2024 – 40; IR 2024 – 273

- **1. Self-only coverage**. For taxable years beginning in 2025, the term " high deductible health plan" as means, for self-only coverage, a health plan that has an annual deductible that is not less than $2,850 and not more than $4,300, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $5,700.

- **2. Family coverage**. For taxable years beginning in 2025, the term " high deductible health plan" means, for family coverage, a health plan that has an annual deductible that is not less than $,5700 and not more than $8,550, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed $10,500.

C. Limit on Health FSA Salary Reduction Contributions under a Cafeteria Plan

- **1. 2024**. For purposes of determining whether health FSA benefit will be a "qualified benefit" for the 2024 plan year, the cafeteria plan must provide the employee may not elect to have a salary reduction contributions exceeding $3,200. (See Rev. Proc. 2023 – 34; IR 2023 – 208)

- **2. 2025**. For purposes of determining whether health FSA benefit will be a "qualified benefit" for the 2025 plan year, the cafeteria plan must provide the employee may not elect to have a salary reduction contributions exceeding $3,300. (See Rev. Proc. 2024 – 40; IR 2024 – 273)

III. Student Loan Interest Deduction

A. General Rule

- 1. A taxpayer may deduct the lesser of $2,500 or the amount of interest paid on a qualified student loan. The deduction is subject to a phased-out based upon modified adjusted gross income in association with the taxpayers filing status.

- 2. The loan must be a qualified student loan. A qualified student loan is a loan the taxpayer took out only to pay qualified education expenses that were:
  - For the taxpayer, spouse, or a person who was your dependent when the taxpayer took out the loan;
  - Paid or incurred within a reasonable period of time before or after the taxpayer took out the loan;
  - For education provided during an academic period for an eligible student.

B. Thresholds

- 1. For 2024, the deduction phases out ratably for taxpayers other than joint filers with MAGI between \$80,000 and \$95,000, and MAGI between \$165,000 and \$195,000 for joint filers. (See Rev. Proc. 2023-34)

- 2. For 2025, the deduction phases out ratably for taxpayers other than joint filers with MAGI between \$85,000 and \$100,000, and MAGI between \$170,000 and \$200,000 for joint filers. (See Rev. Proc. 2024 – 40)

IV. Educators Expense Deduction

A. IR 2024 – 219

- 1. The educator expense deduction remains capped $300 per educator. In other words, a joint filing can claim up to $600 if both spouses are eligible.

- 2. The tax benefit covers out-of-pocket expenses on classroom items like books, supplies, and equipment (including computers and software) as well as COVID-19 safety measures such as masks, disinfectants, and air purifiers.

- 3. Costs for homeschooling or nonathletic supplies for courses in health or physical education are not included.

- 4. The tax benefit may also be used to offset expenses for professional development courses relevant to teaching, though the IRS said it could be more advantageous to use other educational tax benefits like the lifetime learning credit.

V. Alimony

A. Audit Risk Item

- 1. The IRS is indicated that many taxpayers are taking a deduction for alimony and a corresponding taxpayer is not including it in income. The service will give greater scrutiny to the deduction of alimony on tax return as a result.

B. Current Rules on Alimony.

- 1. Alimony is generally deductible from gross income by the pay or an includable in the income of the payee. For payments made to, or on behalf of, former spouses to qualify as a deduction certain requirement must be met and they include the following:

B. Current Rules on Alimony.

- Payment must be made in cash (transfer of property or services do not qualify).
- Payments must be received by spouse (or on behalf of spouse, i.e., indirect alimony).
- Payment is required under divorce or written separation agreement (i.e., no voluntary Payments).
- There is nothing in the agreement designating the payment is not alimony or that the payment is not taxable to the recipient spouse.
- Payee and payer spouse cannot live together (no joint return).
- Alimony must stop after payee spouse's death (state statutes may require if agreement Silent!)
- Payments are not related to a child-related contingency (e.g., child reaches age 18).
- Recapture may be required if "excess front-loading" (i.e., if the alimony payments in the first year exceed the average payments in the second and third year by more than \$15,000 and to the extent the payments in the second year exceed the payments in the third year by more than \$15,000).

B. Current Rules on Alimony.

- Note: Lump sum payments can qualify as alimony. Likewise debt payments cannot qualify.

Examples

- **Rojas v. US 22-70232 (CA – 9, 2024).** The Ninth Circuit affirmed the tax court's decision in determining that a married couple was not entitled to deduct family support payments made by the husband to the ex-wife. According to the divorce documents, the payments were subject to a child -related contingency. The taxpayer argued that the contingency does not apply because a California Superior Court had already determined there was no current child support order in place. The taxpayers further argued that the Full Faith and Credit Act precluded the Tax Court and the iris from relitigating whether family support provisions are child support for tax purposes. The Superior Court's decision simply clarified the category of support as labeled in the divorce decree without commenting on the nature of the support for tax purposes. As such, the Full Faith in Credit Act does not limit nor bar the iris for the Tax Court from relitigating unresolved questions.

Examples

- **Martino, Jr. v. Comm., TC Memo 2024 – 18.** The taxpayer was not entitled to an alimony deduction for payments made to the ex-wife because the payments did not qualify as alimony under the IRS code. During the years at issue, alimony was treated differently since it was generally deductible the pay or and taxable to the payee. To qualify as alimony, the payments had to satisfy various conditions. One of the conditions for the payment to be considered alimony stated that the divorce decree must not designate such payment is a payment which was not includable in gross income and not allowable as a deduction. As such, a non-alimony designation be clearly reflected in the court document. In this case, no single document specify the precise payments to which the taxpayers ex-wife was entitled.

Examples

- The divorce instrument consisted of multiple documents executed over a time frame including the settlement agreement, the divorce decree and consent and contempt orders. The consistent import of the instrument was at the taxpayers payments did not constitute alimony but were installment payments in discharge of property settlement. The switch from a lump sum payment to installment payments to the taxpayers default does not convert the settlement to alimony. The taxpayer argued he was entitled to an alimony deduction because the final consent order issued by the Lower Court did not explicitly state the payments were not includable in gross income of the ex-spouse. The Tax Court read the final order in conjunction the divorce decree and the prior lower court orders. Entirety of the payment was allocated to non-alimony associated with property settlement.

B. Current Rules on Alimony.

- 2. Alimony deduction was allowed for healthcare previous purchase with pretax wages

B. Current Rules on Alimony.

- **Leyh v. Comm., 157 TC 7.** The taxpayer and his spouse had separated and signed an agreement incident to their divorce. Husband promise to pay wife alimony until the fire divorce was granted. As part of the agreement, husband paid for her health and vision insurance. Husband paid over $10,000 in insurance premiums as pretax payroll reductions through his employer's cafeteria plan. On his tax return and filing married filing separately he excluded the premium payments and claimed a deduction for alimony in the amount of the health insurance payments. The IRS disallowed the deduction claiming it was a double deduction by deducting as alimony payments is spouse's health insurance premiums that were paid to him as compensation but excluded from gross income. The Tax Court held that the husband was in town deduct the premiums as alimony.

B. Current Rules on Alimony.

- The court noted the husband received the health insurance compensation of the parties were still married state law recognizes only divorce not a legal separation. The final decree of divorce was not issued until a year later therefore the taxpayers could have filed a joint return and avoid the alimony issue altogether. The wife would then not have been required to include any portion of payments in her income. However because she was required to include them the batching principal of the alimony payments allowed the husband to claim a corresponding deduction. The court indicated was no risk of a windfall to the husband that disallowed the deduction would leave him with a greater tax burden.

C. Transfer Incident to a Divorce

- 1. Under Section 1041, no gain or loss is recognized on a transfer of property from an individual to a spouse or former spouse if the transfer is incident to the divorce. A transfer property is incident to the divorce if the transfer occurs within one year after the date the marriage ceases or is related to the cessation of the marriage.

- 2. A transfer is related to the cessation of the marriage if it is pursuant to a written divorce or separation agreement and the transfer occurs within six years of the divorce.

- 3 A transfer of property incident to a divorce can include business property or the transfer of business interests and thus not result in the transfer being considered a taxable event. (See Belote v. Comm. TCM 2016 – 113)

VI. Retirement and Individual Retirement Accounts

A. Traditional IRA Contributions – 2024; IR 2023 – 203; Notice 2023-75

- 1. The contribution amount is the lesser of:
  - $7,000 or
  - the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.

- **2. Catch-up Contribution**. For 2024, the taxpayer can make a catch-up contribution of $1,000 if they are age 50 or older.

- **3. MAGI Phase out Limitation**. For 2024, the active participation MAGI limitation phase- out is as follows:

A. Traditional IRA Contributions – 2024; IR 2023 – 203; Notice 2023-75

Filing Status	Amount
Single (HOH)	$77,000 – $87,000
Married Filing Joint	$123,000 – $143,000
Married Filing Separately	$0 – $10,000

A. Traditional IRA Contributions – 2024; IR 2023 – 203; Notice 2023-75

- 4. For 2024, a nonworking spouse may make IRA contributions based on the earned income of his or her spouse. For an IRA contributor who is not covered by workplace retirement plan and is married to one who is covered, the MAGI deduction phase out for 2024 is between $230,000 – $240,000.

B. Traditional IRA Contributions – 2025; IR 2025 – 285; Notice 2024 – 80

- 1. The contribution amount is the lesser of:
  - $7,000 or
  - the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.

- **2. Catch-up Contribution**. For 2025, the taxpayer can make a catch-up contribution of $1,000 if they are age 50 or older. The SECURE 2.0 Act of 2022 allows for an annual cost of living adjustment starting next year.

- **3. MAGI Phase out Limitation**. For 2025, the active participation MAGI limitation phase- out is as follows:

B. Traditional IRA Contributions – 2025; IR 2025 – 285; Notice 2024 – 80

Filing Status	Amount
Single (HOH)	$79,000 – $89,000
Married Filing Joint	$126,000 – $146,000
Married Filing Separately	$0 – $10,000

B. Traditional IRA Contributions – 2025; IR 2025 – 285; Notice 2024 – 80

- 4. For 2025, a nonworking spouse may make IRA contributions based on the earned income of his or her spouse. For an IRA contributor who is not covered by workplace retirement plan and is married to one who is covered, the MAGI deduction phase out for 2024 is between $236,000 – $246,000.

C. Roth IRAs Contributions – 2024; IR 2023 – 203; Notice 2023-75

- 1. The contribution amount is the lesser of:
  - $7, 000 or
  - the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.

- a. a. Catch-up Contribution. For 2024, the taxpayer can make a catch-up contribution of $1000 if they are age 50 or older.

- **2. Limitation**. For 2024, the maximum contribution to a Roth IRA is the lesser of $7,000 for the individuals' compensation for the year. The contribution limit is reduced to the extent that a taxpayer makes contributions to any other IRA for the same tax year. The Roth IRA MAGI threshold is shown below:

C. Roth IRAs Contributions – 2024; IR 2023 – 203; Notice 2023-75

Filing Status	Amount
Single (HOH)	$146,000– $161,000
Married Filing Joint	$230,000 – $240,000
Married Filing Separately	$0 – $10,000

D. Roth IRA Contributions – 2025; IR 2025 – 285; Notice 2024 – 80

- 1. The contribution amount is the lesser of:
  - $7, 000 or
  - the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.

- **2. Catch-up Contribution**. For 2025, the taxpayer can make a catch-up contribution of $1000 if they are age 50 or older. The SECURE 2.0 Act of 2022 allows for an annual cost of living adjustment starting next year.

- **3. Limitation**. For 2024, the maximum contribution to a Roth IRA is the lesser of $6,000 for the individuals' compensation for the year. The contribution limit is reduced to the extent that a taxpayer makes contributions to any other IRA for the same tax year. The Roth IRA MAGI threshold is shown below:

D. Roth IRA Contributions – 2025; IR 2025 – 285; Notice 2024 – 80

Filing Status	Amount
Single (HOH)	$150,000– $165,000
Married Filing Joint	$236,000 – $246,000
Married Filing Separately	$0 – $10,000

E. Other Retirement Plan Amounts

- **1. Defined Benefit Plan.**
  - For 2024, the maximum single life annuity for a defined benefit plan will be $275,000. (Notice 2023-75, 2023-47 IRB)
  - For 2025, the maximum single life annuity for a defined benefit plan will be $280,000 (Notice 2024 – 80)

- **2. Defined Contribution Plan.**
  - For 2024, the maximum annual addition to a defined contribution plan will be $69,000. (IR 2023 – 203; Notice 2023-75, 2023-47 IRB)
  - For 2025, the maximum annual addition to defined contribution plan will be $70,000 (Notice 2024 – 80)

- **3. Annual Contribution Limit**
  - For 2024, the maximum amount of compensation that can be taken into account under any qualified plan allocation or benefit formula will be $345,000. (Notice 2023-75)
  - For 2025, the maximum amount of compensation that can be taken into account under a qualified plan allocation or benefit formula will be $350,000. (Notice 2024 – 80)

E. Other Retirement Plan Amounts

- **4. SIMPLE Plan.**
  - For 2024, the amount of the deferral is $16,000. (Notice 2023-75)
  - For 2025, the amount deferral is 16,500 left. (Notice 2024 – 80

- **5. SEP**
  - The dollar amount will remain the same for 2024 and 2025. (Notice 2023-75, 2024 – 80)

- **6. 401(k) or 403(b) Plan.**
  - For 2024, the maximum amount of deferral is $ 23,000. (Notice 2023-75)
  - For 2025, the max amount deferral $23,500 (Notice 2024 – 80)

E. Other Retirement Plan Amounts

- **7. Highly Compensated Employee.**
  - For 2024, the minimum compensation of an employee owning less than 5% of the stock of the employer to be treated as a highly compensated employee shall be $155,000. (Notice 2023-75)
  - For 2025, the minimum compensation of employee owning less than 5% the stock of the employer to be treated as a highly compensated employee shall be $160,000
- **8. Key employee in top-heavy plan.**
  - For 2024, the dollar limit is $ 220,000. (Notice 2023-75)
  - For 2025 the dollar limit is $230,000. (Notice 2024 – 80)
- **9. Government, etc. deferred compensation plans.**
  - For 2024, the limit on deferrals is $ 23,000. (Notice 2023-75)
  - For 2025, the limit on deferrals is $23,500 (Notice 2024 – 80)

F. SECURE 2.0 Act – RMD’s

- **1. IRS Continues to Change Applicability Date for Final RMD Regulations – Notice 2024 – 35, 2024 – 19 IRB**

- a. The Service has again provided transition relief for RMD’s and change the applicability date of the final RMD regulations. The final regulations that the IRS intends to issue will not apply for determining RMD’s before January 1, 2025.

F. SECURE 2.0 Act – RMD's

- b. But notice also states a defined contribution plan that failed to make a specified RMD will not be treated as having failed to satisfy the plan requirement solely because it did not make that distribution and taxpayers who did not take the specified RMD will not be subject to the excise tax. A specified RMD is any distribution that will be required to be made 2024 for the year in which the employee or designated beneficiary died if that payment would be required to be made to an employee's designated beneficiary because the employee or IRA owner died in 2020, 21, 22 or 23 on or after the account owners required beginning date and the beneficiary is not using the lifetime or life expectancy payment exceptions or a beneficiary of an eligible designated beneficiary who died during the same timeframe and that designated beneficiary was using the lifetime or life expectancy payment options.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- 1. The IRS has issued final regulations updating the required minimum distribution (RMD) rules applicable to qualified plans, including 401(k) plans, to reflect changes made by the SECURE and SECURE 2.0 Acts. These regulations generally follow proposed regulations released in 2022, with some changes and clarifications.

- 2. The IRS has also released proposed regulations addressing additional RMD issues under the SECURE 2.0 Act that are specifically reserved in the final regulations.

- 3. The final rules generally apply when determining RMDs for calendar years beginning on or after January 1, 2025, using a reasonable, good faith interpretation of SECURE Act amendments and, for 2023 and 2024 distribution calendar years, SECURE 2.0 Act amendments.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- **4. Distributions Beginning During Employees Life**. . Generally, the required beginning date (RBD) is April 1 of the year after the later of the year the employee reaches the applicable age or retires. The applicable age varies:
  - 70-1/2 for those born before July 1, 1949;
  - 72 for those born on or after July 1, 1949, and before January 1, 1951;
  - 73 for those born on or after January 1, 1951, and before January 1, 1959; and
  - 75 for those born on or after January 1, 1960.

- a. According to the preamble, plans can provide for a uniform RBD of the calendar year following the year an employee attains age 70-1/2 for administrative ease. The proposed regulations would resolve a conflict in the SECURE 2.0 Act regarding applicable ages for employees born in 1959 by providing an applicable age of 73.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- 5. The final regulations reflect the Code's changes regarding RMDs for designated beneficiaries of employees who die before their RBD, including that only "eligible" designated beneficiaries may receive distributions over their life expectancy. If an employee's entire interest is in a designated Roth account, no lifetime distributions are required.

- a. In essence, upon the employee's death, that employee is treated as having died before their RBD. Annual distributions must continue in accordance with the final regulations until the account is fully distributed. Plans may specify distribution methods or limit distribution method elections for certain categories of eligible designated beneficiaries, such as allowing only an employee's surviving spouse to choose between the ten-year rule and life expectancy payments.

- **6. Eligible Designated Beneficiary**. An eligible designated beneficiary is a designated beneficiary who is:

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- A surviving spouse
- A minor child
- Disabled
- Chronically Ill or
- 10 or fewer years younger than the employee

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- a. Beneficiaries under the age of 18 must have a medically determinable physical or mental impairment resulting in marked and severe functional limitations and expected to result in death or to be of the long and indefinite duration.

- b. A safe harbor allows beneficiaries to be deemed disabled for RMD purposes if they are determined to be disabled by the Social Security Commissioner.

- c. Documentation of a disability or chronic illness must be provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the employee's death.

- d. In certain cases, certifications from licensed health care practitioners are required. Plan administrators may not rely on a beneficiary's self-certification of disability or chronic illness.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- **7. Partial account purchase of annuity contracts**. A plan may allow employees to elect to have an RMD distributed for a calendar year in an amount equal to the excess of the total of the required amount for that year over the annuity amount.

- a. As an alternative to the general bifurcation rule, a plan may allow an employee to satisfy the RMD requirement applicable to the annuity contract and the remaining account balance by adding the fair market value of the annuity contract to the remaining account balance and treating the payments under the annuity contract as distributions from the individual account.

- b. Under the proposed regulations, the fair market value of the annuity would be determined as of December 31 of the calendar year preceding the distribution calendar year.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- **8. Distributions after employee's death**. The final regulations maintain the requirement in the 2022 proposal for continued annual distributions when employees die on or after their RBD.

- a. The annual distributions generally must continue when an individual has started RMDs, even though the Code provides that full distribution must be made by the tenth anniversary of the employee's death.

- Also maintained is the obligation for ongoing annual distributions for a period of up to ten years following:
  - the death of an eligible designated beneficiary who was taking life expectancy payments, or
  - attainment of the age of majority by an eligible designated beneficiary who was a minor child of the employee receiving life expectancy payments.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- **9. Surviving spouses**. Consistent with the SECURE 2.0 Act, a surviving spouse who is the employee's sole beneficiary may elect to be treated as the employee for certain purposes.

- a. The proposed regulations would provide that if the employee dies before the RBD and the sole beneficiary is the surviving spouse who is subject to the life expectancy rule, then the spouse would automatically be treated as making the election.

- b. If the employee dies on or after the RBD, then the corresponding election would not apply automatically, unless the plan's written terms made the election automatic.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- **10. Multiple designated minor beneficiaries**. If an employee has more than one child as eligible designated beneficiaries, a full distribution is not required until ten years after the youngest of the employee's children who are designated beneficiaries attains the age of majority or, if earlier, ten years after the last of those minor children dies.

- **11. Designated Roth accounts**. When determining the account balance subject to the RMD rules, amounts held in a designated Roth account are disregarded. Under the proposed regulations, distributions from designated Roth accounts would not count toward satisfying any RMD but could be rolled over to a Roth IRA if they otherwise qualified as eligible rollover distributions

- **12. Corrective distributions**. The final regulations provide an automatic waiver of the Section 4974 excise tax associated with a beneficiary's failure to take a RMD in the calendar year in which an individual died if that individual had not already satisfied the RMD for that year, provided that the failure is corrected by the end of the following calendar year. This corrective distribution is not eligible for rollover.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- a. Under the proposed regulations, if a missed RMD is corrected by a distribution in a subsequent calendar year, the RMD for that subsequent year would have to be made in addition to the corrective distribution.

G. IRS Issues Final and Proposed RMD Regulations Reflecting SECURE and SECURE 2.0 Act

- **13. Trusts as designated beneficiaries**. Certain beneficiaries of a see-through trust are regarded as beneficiaries of an employee if specific conditions are met. The trust must
  - be valid under state law or would be if it had corpus;
  - be irrevocable or become irrevocable upon the employee's death;
  - have identifiable beneficiaries; and
  - meet documentation requirements.

- a. When determining whether there are identifiable beneficiaries, beneficiaries are treated as if they could receive amounts in the trust representing the employee's interest in the plan, regardless of whether those amounts are disbursed directly to the beneficiaries or indirectly for their benefit . For example, in the case of payments to a custodial account for the benefit of a minor child.

- b. With respect to the documentation requirement, the plan administrator may require a trustee to provide a list of trust beneficiaries with a description of the conditions on their entitlement, instead of a trust document.

H. SECURE 2.0 Provisions Taking Effect in 2024.

- **1. Catch-up**. For taxpayers who are at least age 50 before the end of the tax year, the IRA contribution deductible amount will be increased by catch-up contribution amount of $1,000 which is now indexed for inflation.

- **2. Employer Matching Contributions for Student Loan Payments.** Employers can make matching contributions under a 401(k) plan, 403(b) plan, 457 plan or SIMPLE IRA plan with respect to qualified student loan payments.

- **3. No Early Withdraw Penalty for Emergency Personal Expenses**. The 10% early withdrawal penalty will not apply to an emergency personal expense distribution from an eligible defined contribution plan. The withdraw can occur once yearly. The administrator of the plan may rely on the employee’s self-certification as to the personal emergency. A limitation of $1,000 applies. If the withdrawn amount is re-contributed within three years it does not become taxable.

H. SECURE 2.0 Provisions Taking Effect in 2024.

- **4. Additional Nonelective** Contributions to SIMPLE Plans. Employers may make additional nonelective contributions of up to 10% of compensation for each eligible employee with at least $5000 of compensation for the year. These nonelective contributions may not exceed $5000 for any employee for the tax year.

- **5. Increase in SIMPLE Plan Contribution Limits**. The maximum contribution limit is 110% of $10,000 adjusted for inflation in effect for the tax year 2024 for as long as the employer meets certain qualifications including having no more than 25 employees or elect for the increase to apply. If neither of these applies the $10,000 amount would be the application. The catch-up limit is 110% of the catch-up dollar amount in effect for 2024.

H. SECURE 2.0 Provisions Taking Effect in 2024.

- **6. Starter 401(k)s and Safe Harbor Deferral only 403 (b)'s**. Employers that do not currently maintain a plan may set up a starter 401(k) deferral only arrangement or a safe Harbor deferral only 403(b) plan. These plans are treated as meeting nondiscriminatory tests. For both automatic enrollment and participation requirements apply. No employer contributions may be made in employee contributions are limited to $6,000 indexed for inflation.

- **7. Tax-free Rollovers from 529 plans to Roth IRAs**. The 529 plan has been maintained for 15 years, a distribution is not included in income nor subject to the early withdraw bounty if it is a direct transfer from the 529 plan to a Roth IRA maintains the designated beneficiary of the 529 plan.

- **8. Adoption of Discretionary Amendments**. Discretion plan amendments that increase participants benefits can be adopted by the due date of the employer's tax return.

H. SECURE 2.0 Provisions Taking Effect in 2024.

- **9. Designated Roth Accounts exempt from predeath RMD rules**. While the account owners alive RMD's are not required from designated Roth accounts beginning in 2024.

- **10. Surviving Spouse Election to use Uniform Lifetime kept able to determine RMD**. A surviving spouse who is the only beneficiary of the deceased plan participant or IRA owner plan may elect to have RMDs determined using the Uniform Lifetime Table rather than the Single Life Table. This allows special beneficiaries to avoid having to roll the inherited benefits into an IRA to get the benefit of a longer distribution. And smaller RMD obligations.

H. SECURE 2.0 Provisions Taking Effect in 2024.

- **11. Catch-up Contributions of Higher Aid Employees must be Designated Roth Contributions**. If a participant in a 401(k), 403(b) or 457 plan whose wages for the preceding year exceed $ 145,000 make catch-up contributions, those contributions must be designated Roth contributions made under an employee election. The catch-up contributions are made on an after-tax basis.

I. Notice 2024 – 2

- 1. The Notice provides guidance in a question-and-answer format with respect to issues under the following sections of the SECURE 2.0 Act:

I. Notice 2024 – 2

- 101 – expanding automatic enrollment in retirement plans
- 102 – modification of credit for small employer pension plan startup costs
- 112 – military spouse retirement plan eligibility credit for small employers
- 113 – small immediate financial incentives for contributing to a plan
- 117 – contribution limit for SIMPLE plans
- 326 – exception to the additional tax on early distributions from qualified plans for individuals with a terminal illness
- 332 – employers allowed to replace SIMPLE retirement accounts with safe harbor 401(k) plans during a year
- 348 – cash balance
- 350 – safe harbor for correction of employee elective deferral failures
- 501 – provisions relating to plan amendments
- 601 – SIMPLE and SEP Roth IRAs
- 604 – optional treatment of employer contributions or nonelective contributions as Roth contribution

I. Notice 2024 – 2

- **2. Automatic Enrollment for New Plans** A less an exception applies Section 101 requires new 401(k)s and 403(b) plans to automatically roll participants at a minimum initial rate of 3% of their compensation. The rate must be increased by 1% each year until it reaches at least 10%. This requirement applies to plan years beginning after 2024 but does not apply to plans established prior to December 29, 2022. The notice provides the following clarifications regarding mandatory automatic enrollment:

- a. A plan is "established" on the date the plan is adopted, even if the plan takes effect after the adoption date. So, a plan adopted prior to December 29, 2022 (a pre-enactment plan), is exempt from mandatory automatic enrollment, even if the plan first became effective after enactment of SECURE 2.0.

I. Notice 2024 – 2

- b. In the case of the merger of two single employer pre enactment plans, the merged plan is treated as a pre enactment plan. The result is the same if a single employer pre-enactment plan is merged with a pre-enactment plan maintained by more than one employer.

- c. If a pre-enactment plan is merged with a plan established after the enactment of SECURE 2.0, the general rule is that the mandatory automatic enrollment provisions of SECURE 2.0 apply to the merged plan. However, an exception applies in the case of certain business mergers and acquisitions if the plan merger is accomplished within the coverage transition period defined in the Internal Revenue Code (IRC), which generally is by the end of the plan year following the corporate merger or acquisition. Another exception applies if a "new" plan is merged with a pre enactment plan maintained by more than one employer (e.g., a multiple employer plan). In such cases, the pre enactment plan remains grandfathered, but the portion of the merged plan attributable to the "new" plan would be subject to the mandatory automatic enrollment requirements of SECURE 2.0.

I. Notice 2024 – 2

- d. If a plan is spun off from a pre enactment plan, the spun off plan is also treated as a pre-enactment plan. However, if the plan from which the new plan was spun off was a plan maintained by more than one employer that was established before December 29, 2022, the spun-off plan is treated as a pre enactment plan only if the participants in the spun-off plan were previously treated as participating in a pre-enactment plan.

- e. Section 414A(c)(2)(B) of the Code provides that, in the case of an employer adopting a plan maintained by more than one employer after the date of the enactment of section 101 of the SECURE 2.0 Act, section 414(c)(2)(A) of the Code does not apply to that employer, and section 414A(a) applies with respect to that employer as if that plan were a single plan.

- f. Section 101(c) of the SECURE 2.0 Act provides that the amendments made by section 101 apply to plan years beginning after December 31, 2024.

I. Notice 2024 – 2

- **3. Small Immediate Financial Incentives (De minimis).** Section 113 of the Act provided that a de minimis financial incentive (one not paid for with plan assets) provided to employees who elect to participate in the plan will not violate the contingent benefit rule, which prohibits conditioning any benefit—other than employer matching contributions—on a decision to participate in the plan. This provision also provides relief from the prohibited transaction rules in the IRC and the Employment Retirement Income Security Act (ERISA). The notice includes the following clarifications regarding these incentives:

I. Notice 2024 – 2

- a. A financial incentive is de minimis only if it does not exceed $250 in value.
- b. A plan can only offer de minimis financial incentives to employees who do not have deferral elections already in effect.
- c. A plan can provide de minimis financial incentives in installments that are contingent on the employee continuing to defer, even if those installments are paid over more than one plan year.

I. Notice 2024 – 2

- d. A de minimis financial incentive is includible in the employee’s gross income and wages and is subject to applicable withholding and reporting requirements, unless the incentive satisfies an exception under the IRC (e.g., nontaxable fringe benefits).

I. Notice 2024 – 2

- **4. Deadlines for Plan Amendments**. Section 501 of the Act generally provides for a plan amendment deadline on the last day of the first plan year beginning on or after January 1, 2025 for any changes made to the plan by the Act for subsequent regulations.. The notice does change the deadlines for plan amendments as follows:

- a. The guidance provides a new plan amendment deadline of December 31, 2026, for qualified plans and 403(b) plans. For governmental 401(a) and 403(b) plans, the plan amendment deadline is extended to December 31, 2029.

- b. The plan amendment deadline for applicable collectively bargained plans is extended to December 31, 2028.

- c. For governmental 457(b) plans, the plan amendment deadline is extended to the later of December 31, 2029, or, if applicable, the first day of the first plan year beginning more than 180 days after the date of notification by the Treasury secretary that the plan was administered in a manner that is inconsistent with the requirements of Section 457(b) of the Code.

I. Notice 2024 – 2

- **5. Roth Employer Contributions**. Section 604 of the Act allows a 401 (a) plan, including 401(k) plan, 403(b) plan or 457 (b) plan to permit employees to designate employer matching or nonelective contributions. These are nonforfeitable at the time they are received as designated Roth contributions the provision was effective for contributions made after December 29, 2022. The notice makes the following clarifications regarding designated Roth employer contributions:

I. Notice 2024 – 2

- a. Rules similar to the rules for designated Roth elective contributions apply to designated Roth employer contributions, except that Roth employer contributions need not satisfy the rules applicable to elective contributions, such as the special distribution restrictions and inclusion in the ADP test. For example, designation of employer contributions as Roth contributions must be made no later than the time that the contribution is allocated to an employee’s account and must be irrevocable. Also, designated Roth employer contributions are subject to income inclusion treatment and separate accounting rules. In addition, an employee must have an effective opportunity to make (or change) their designation of a Roth employer contribution election at least once during each plan year.

I. Notice 2024 – 2

- b. A designated Roth employer contribution is includible in gross income for the taxable year in which the contribution is allocated to the individual's account. An employer contribution may be designated as a Roth contribution only if the employee is fully vested in the contribution at the time it is allocated to the employee's account.

- c. If employer contributions are subject to a vesting schedule, an employee's right under the plan to designate 100% vested employer contributions as Roth contributions will not be treated as failing to satisfy Section 401(a)(4) of the IRC, even if that right is not currently available to a group of employees (i.e., because they are not 100% vested).

I. Notice 2024 – 2

- d. Designated Roth employer contributions are not wages for purposes of federal income tax withholding. However, an employee who designates an employer contribution as a Roth contribution may need to increase their withholding or make estimated tax payments to avoid an underpayment penalty.

- e. Roth employer contributions made to a 401(a) or 403(b) plan are not wages for purposes of FICA and FUTA taxes.

- f. Roth nonelective contributions to a governmental 457(b) plan are wages for purposes of FICA but only if FICA taxes normally apply to such employees (such as state and local government employees who are not members of a state or local retirement system). Roth nonelective contributions made to a governmental 457(b) plan are not subject to FUTA taxes.

I. Notice 2024 – 2

- g. The reporting obligations that apply to Roth employer contributions are the same as if, upon allocation to that account, the contribution had been directly rolled over to a designated Roth account in the plan as an in-plan Roth rollover. Thus, designated Roth employer contributions are reported in boxes 1 and 2a of Form 1099-R, and code "G" is used in box 7.

- h. Plans may limit the contribution sources (i.e., deferrals, matching contributions, and/or nonelective contributions) that are eligible to be designated as Roth contributions. However, the right to make designated Roth contributions is a right or feature subject to the requirements of Section 401(a)(4).

I. Notice 2024 – 2

- **6. SIMPLE Plans**. The notice does discuss Section 117 additional employer contributions to a Savings Incentive Match Plan for employees (SIMPLE) individual retirement account or SIMPLE 401 (K) plan by increasing the annual salary reduction/elective contribution limits and the limit on additional catch-up contributions beginning at age 50.

- a. The act allows for an increase to both the annual salary reduction contribution/elective contribution limit and the limit on additional catch-up contributions beginning at age 50 for a SIMPLE IRA plan or a SIMPLE 401(k) plan for certain eligible employers. For some of those eligible employers, the increased limits apply automatically; while other of those eligible employers must make an election for the increased limits to apply and must also make additional employer contributions. The increased limits are 110 percent of the otherwise applicable limits for 2024.

I. Notice 2024 – 2

- b. The increased limits apply automatically in the case of an eligible employer described in section 408(p)(2)(E)(iv) that has no more than 25 employees who received at least $5,000 of compensation for the preceding calendar year. For an employer that has more than 25 employees who received at least $5,000 of compensation for the preceding year, the increased limits apply only if the employer makes an election for the increased limits to apply. If the employer makes an election for the increased limits to apply, the employer must provide higher matching or nonelective contributions,

- c. An employer that must make an election to apply the increased limits must take formal written action to make an election to reflect the increased limits and should maintain documentation of the election in the plan's records. An employer (including employers for whom the increased limits apply automatically) must reflect the increased limits in the plan terms.

I. Notice 2024 – 2

- d. If an employer makes an election to apply the increased limits, the employer must make matching contributions equal to the employee’s salary reduction contributions or elective contributions that do not exceed 4 percent (increased from 3 percent) of the employee’s compensation or make a nonelective contribution of 3 percent (increased from 2 percent) of the employee’s compensation (regardless of whether the employee elects to make contributions).

I. Notice 2024 – 2

- e. The employer must notify employees of the increased limits. The notice must be included in the annual employer notification that informs employees of the opportunity to enter into a salary reduction agreement or to modify a prior agreement. In the case of an employer for whom the increased limits apply pursuant to an election, the employer also must notify employees of the increased matching contribution or increased nonelective contribution. The employer should also (1) notify the SIMPLE IRA plan's or SIMPLE 401(k) plan's financial institution and payroll provider of the increased limits, and (2) keep records of all actions concerning the increased limits. However, the employer does not need to notify the IRS of the election to apply the increased For 2024 the increase in both the annual salary reduction contribution/elective contribution limit is 110%

I. Notice 2024 – 2

- **7. SIMPLE IRA**

- a. Under section 408(p)(2)(D), an employer that maintains a SIMPLE IRA plan for a calendar year generally is not permitted to maintain another plan, contract, pension, or trust described in section 219(g)(5)(A) or (B) to which contributions were made or benefits were accrued for service in the year.

- b. Prior to the act, if a distribution comes from a SIMPLE IRA within the first two years of the individual’s participation in the plan, the individual could only roll over the distribution to another eligible retirement plan if the other eligible retirement plan was a SIMPLE IRA.

I. Notice 2024 – 2

- c. The Act allows an employer to elect at any time during the year to terminate qualified salary reduction arrangement under a SIMPLE IRA plan if the employer establishes and maintains a safe harbor 401(k) plan to replace the terminated arrangement.

- d. The Act also indicates the limit on rollovers of a distribution from a SIMPLE IRA plan does not apply if an employer terminates the qualified salary reduction arrangement and establishes a section 401(k) or section 403 (b) plan provided that the amount is paid in a rollover contribution.

I. Notice 2024 – 2

- 8. Under Section 601 of the Notice and SECURE 2.0 and allowances now made to permit an employee who participates in a SIMPLE IRA or SEP arrangement to designate a Roth IRA as the IRA for which contributions under the plan can be made.

- a. Specifically, a Roth IRA will not be treated as a SEP unless the employee elects for the Roth IRA to be so treated.

- b. Any contribution under a SEP made to a Roth IRA is not includable in the employee’s gross income. Likewise, any contribution under a SIMPLE IRA which is made to a Roth IRA is not includable in the employee’s gross income.

J. Retirement Rollovers

- 1. Amounts received from an IRA or qualified plan may be rolled over tax-free within 60 days of the date of the distribution. The IRS may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster or other events beyond the reasonable control of the individual subject to such requirement.

- **2. Self-Certification Procedure for Certain Failed 60-Day Rollovers Modified – Rev. Proc. 2020-45.** This revenue procedure modifies and updates Rev. Proc. 2016-47, 2016-37 I.R.B. 346. Section 3.02(2) of Rev. Proc. 2016-47 provides a list of permissible reasons for self-certification of eligibility for a waiver of the 60-day rollover requirement.

J. Retirement Rollovers

- a. Effective August 24, 2016, the IRS has provided a self-certification procedure designed to help recipients of retirement plan distributions who inadvertently miss the 60-day rollover time limit for properly rolling these amounts into another retirement plan or IRA.

- b. A taxpayer may make a written certification to a plan administrator or an IRA trustee that a contribution satisfies the conditions in Section 3.02 of this revenue procedure. This self-certification has the effects described in Section 3.04 of this revenue procedure. Taxpayers may make the certification by using the model language in the appendix on a word-for-word basis or by using language that is substantially similar in all material respects. A copy of the certification should be kept in the taxpayer's files and be available if requested on audit.

J. Retirement Rollovers

- c. Conditions for self-certification.

J. Retirement Rollovers

- The IRS must not have previously denied a waiver request with respect to a rollover of all or part of the distribution to which the contribution relates.

- The taxpayer must have missed the 60-day deadline because of the taxpayer's inability to complete a rollover due to one or more of the following reasons:

J. Retirement Rollovers

- An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;
- The distribution, having been made in the form of a check, was misplaced and never cashed;
- The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;
- The taxpayer's principal residence was severely damaged;
- A member of the taxpayer's family died;
- The taxpayer or a member of the taxpayer's family was seriously ill;
- The taxpayer was incarcerated;
- Restrictions were imposed by a foreign country;
- A postal error occurred;
- The distribution was made on account of a levy under § 6331 and the proceeds of the levy have been returned to the taxpayer;
- The party making the distribution to which the rollover relates delayed providing information that the receiving plan or ira required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information; or
- The distribution was made to a state unclaimed property fund.

J. Retirement Rollovers

- The contribution must be made to the plan or IRA as soon as practicable after the reason or reasons listed in the preceding paragraph no longer prevent the taxpayer from rolling over the amount distributed (which includes any amount withheld for income tax) or a lesser amount if the taxpayer wants to roll over less than the total amount distributed or if part of the amount distributed is ineligible for rollover. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

- An IRA trustee that accepts a rollover contribution after the 60-day deadline reports on Form 5498 that the contribution was accepted after the 60-day deadline.

J. Retirement Rollovers

- **3. Inherited IRAs and Surviving Spouse Rollovers.**

- a. Taxpayer as surviving spouse would be treated as having acquired the IRA upon decedent's death passing to a trust of which the taxpayer was the sole trustee and beneficiary as if it was directly from the decedent rather than from the trust. Taxpayers eligible to roll over the IRA distribution to an IRA or establish and maintain an IRA in her own name provide the rollover occurs within 60 days. (PLR 202404003, 202322013, 202322014)

- b. Surviving Spouse was eligible to roll over proceeds of IRA that were not in excess of stated percent of specified residue of trust to IRA set up and maintain in surviving spouse's name provided the rollover curve within 60 days after the proceeds were distributed. Except in the case of a rollover to a Roth IRA none of the proceeds would be includable in spouse's gross income. (PLR 202348009)

J. Retirement Rollovers

- **4. Waivers Granted Beyond self certification**

- **a. PLR 202441015, 202430010, 202244029 – Fraud**. Waiver 60 day rollover requirement with respect taxpayers attended transfer of stated amount from an IRA was allowed because the taxpayer was a victim of a fraud scheme.

- **b. IRS Letter Ruling 202218028 – Medical Condition and Spouse Death**. The taxpayer had a severe medical condition diagnosed before the tax year at issue. She withdrew amounts from her 401(k) and IRA plan in the same year and failed to roll either distribution over. Her husband had manage her financial affairs but he died before the distributions were taken, the 60 day rollover period expired. The taxpayer survived and recovered from her health issues and submitted a request of waiver of the 60 day rollover requirement based upon medical condition and spouse's death. The taxpayer was required to prove the medical condition and death and the service waive the requirement.

J. Retirement Rollovers

- **c. IRS Letter Ruling 202214008 – Estate Named as Beneficiary**. The decedent opened an IRA and named himself as the beneficiary. Upon his death, the custodian transferred the IRA to a beneficiary In the name of his estate. The taxpayer who had died had not reached age 72 so the benefits would've been subject to the five-year rule. The taxpayer left a will naming his surviving spouse as both executor of the estate and sole beneficiary of the estate. The IRS allows the taxpayer's surviving spouse to have the beneficiary IRA transferred to a new IRA in her name without tax consequences.

J. Retirement Rollovers

- **d. IRS Letter Ruling 202227005 – Joint Trusts**. The decedent’s IRA was payable to a joint trust that stated that any retirement assets will be allocated to a survivor’s trust after the death of the first spouse. The decedent’s two IRAs were transferred to a new inherited IRA at his death. With respect to the new IRA allocated to the survivor’s trust, the taxpayer had the right to distribute the new IRA to the taxpayer or any part of it to the taxpayer. The taxpayer as the surviving spouse was also the trustee and sole beneficiary of the survivor’s trust. The taxpayer who was the surviving spouse desire to rollover the inherited IRA into one or more IRAs in her individual name. Since no third-party could prevent the taxpayer from receiving the proceeds of the IRA and from rolling over the proceeds into her own IRA, the IRS allows the tax-free rollover of the inherited IRA.

J. Retirement Rollovers

- **5. Bankruptcy Issues**

- a. Taxpayers are entitled to bankruptcy exemption relief regarding early retirement plan distributions made before turning age 59 ½ where the early distribution was also called associated with a claimed disability exemption. (In re Majeski, Bktcy Ct MI 131 AFTR 2d 2023 – 655)

- b. Taxpayers were entitled to bankruptcy exemption regarding IRA up to amount of IRA contribution limit for the stated year under bankruptcy, amounts in excess of the limit are considered excess distribution not exempt from the bankruptcy. (In re Brainard, Bktcy Ct 131 AFTR2d 2023-694)

J. Retirement Rollovers

- c. Taxpayers are not entitled to bankruptcy exceptions involving improper rollovers of IRAs, Roth IRAs into 401(k)s and distributions as they are no longer considered essential characteristics of so with retirement funds protected from bankruptcy. (In re Jacobs, Bktcy Ct. 132 AFTR 2d 2023 – 5337)

- d. Taxpayers lost their right to claim funds from IRA as exempt assets due to transfers of funds from the IRA to the taxpayer's businesses which were used to pay for both business and personal expenses. Such transfers are viewed as prohibited transactions under Code Section 4975 (c). Which caused the IRAs to lose her status as qualified IRAs and are now non-exempt property available for creditors. (In Re Langston, Bktcy Ct, ND Texas, 132 AFTR2d 2023 – 5067)

J. Retirement Rollovers

- **e. Qualified versus Nonqualified Plans**. The taxpayer chose to participate in his employer's Section 409A deferred compensation plan was allowed only if the employee no longer contributed to the employer's 401(k) plan. Subsequently, the employer filed for bankruptcy protection. The employer liquidated the form nine plan and made secure claim distributions to nonqualified participants believing that the taxpayer and other employees were not qualify to participate originally in the 409A plan. Benefits were distributed less 20% federal withholdings. The taxpayer requested to shares Section 409A plan transferred to the employer's 401(k) plan. The bankruptcy court indicated could not orders the funds from his nonqualified plan be deposited into a qualified plan and that the taxes were properly withheld. The court determined that the employees including the taxpayer had been given enough disclosure that the Section 409A plan was not a qualified plan when the taxpayer voluntary decided to participate. (See Palaniappann v. Comm.,No. 2:2 2 – CV – 01685 (DC Arizona 3/28//24)

K. Early Withdrawal Penalties

- 1. Section 72(t)(1) imposes a 10% additional tax on distributions from qualified retirement plans. However, Section 72(t)(2) lists the following exceptions to the imposition of the 10% additional tax on the distributions:

K. Early Withdrawal Penalties

- a. On or after the account owner reaches age 59 ½ .
- b. The death of the account owner.
- c. After the permanent disability of the account owner.
- d. At age 55 if from an employer plan and separated from service (does not apply to IRAs).
- e. A series of substantially equal periodic payments made for the life of the employee or the joint lives of the employee and his beneficiary.
- f. Distribution made incident to a divorce or made to an alternate payee under a QDRO.
- g. IRS levies.

K. Early Withdrawal Penalties

- h. For extraordinary medical expense that exceed 7 ½ % of AGI.
- i. Qualified disaster-relief distribution not in excess of $100,000.
- j. Public safety employees taking plan distributions if separating from service and over age 50.
- k. Reservists called to active duty for at least 179 days.
- l. For health insurance premiums during long term unemployment (12 consecutive weeks).- IRA ONLY

K. Early Withdrawal Penalties

- m. For qualified higher education expense – IRA ONLY.
- n. For a qualified 1st time home buyer (a $10,000 lifetime limit) – IRA ONLY.
- o. 10% Penalty Exception for Qualified Reservists
- p. Financial Hardship Does not Count as far as an IRA. (Prichard V. Comm., TCM 2017 – 136; Cheves v. Comm., TCM 2017 – 22)

Examples

- **Moran v. Comm., TC Memo 2024 – 67**. Taxpayer was under age 59 ½ and took a distribution from an IRA in the amount of $2,417. The IRS assessed the additional 10% tax on early retirement plan distributions. Taxpayer failed to provide any exception to the additional tax other than stating it was unfair.

- **Kohl v. Comm., TC Summary 2024 – 4.** The taxpayer withdrew money from her IRA to pay rent and avoid eviction. The test picketed the 10% penalty should not apply based on the exception for withdrawal for emergency expenses as enacted as part of SECURE 2.0. Law change applied only to withdraws from qualified retirement plans made after December 31, 2023 the court held it cannot prevent the county from being assessed against her.

- **Scott v. Comm., TC Memo 2023 – 141.** Taxpayer failed to report Form 1099 – R taxable distribution in the amount of $14,386. The distribution was early distribution as the taxpayer had not reached the age of 59 ½ at the time of the distribution. The Form 1099 – R stated early distribution, known known exception. Taxpayer acknowledged receipt and was unaware of the 10% penalty to be assessed.

K. Early Withdrawal Penalties

- **2. Other Penalty Free Provisions**. The SECURE 2.0 Act adds a number of exceptions from the Section 72 (t) tax on early distributions from retirement accounts. These include the following:

- **a. Penalty Free Emergency Withdrawals**. The new exception applies to certain distributions used for emergency expenses, which are used for meeting unforeseeable or immediate financial needs relating to necessary personal or family emergencies. One distribution is allowed per year of up to $1,000. Taxpayers have the option to repay the distribution within three years. No further emergency distributions are allowed during the three-year repayment period unless repayment has been made. The exception is available for distributions made after December 31, 2023.

K. Early Withdrawal Penalties

- **b. Penalty-free withdrawals for domestic abuse victims.** The act amends Section 72(t) to allow domestic abuse victims to take distributions of up to $10,000 (adjusted for inflation after 2024) from a qualified retirement plan without being subject to the 10% additional tax for early withdrawals. "Domestic abuse" includes physical, psychological, sexual, emotional, or economic abuse by a spouse or domestic partner. Employees or participants can self-certify that they qualify for the exception. The provision is effective for distributions made after December 31, 2023.

K. Early Withdrawal Penalties

- **c. Penalty-free withdrawals for individuals with terminal illness**. The act amends Section 72(t) to allow individuals with a terminal illness to take distributions from a qualified retirement plan without being subject to the 10% additional tax for early withdrawals. Employees or participants will need a physician's certification to qualify for the exception. A terminally ill person is defined as someone who has an illness or physical condition that can reasonably be expected to result in death in 84 months or less after the date of the certification. The provision is effective for distributions made after December 31, 2023.

K. Early Withdrawal Penalties

- **d. Penalty-free withdrawals in connection with qualified disasters**. The act allows penalty-free withdrawals of up to $22,000 for "qualified disaster recovery distributions." These are defined as any distribution made on or after the first day of the "incident period" of a qualified disaster and before 180 days after the "applicable date" for that disaster. Eligible individuals must have their principal place of abode within the qualified disaster area and must have sustained an economic loss as a result of the qualified disaster. The "incident period" means the period designated by the Federal Emergency Management Agency as the period during which the disaster occurred.

K. Early Withdrawal Penalties

- The "applicable date" is the latest of (i) the date of enactment of the act, (ii) the first day of the incident period, or (iii) the date of the disaster declaration. Any amount of a qualified disaster recovery distribution that an individual must include in income will be included ratably over a three-year period. The provision applies to distributions with respect to disasters for which the incident period begins on or after January 26, 2021 (30 days after the enactment of the Taxpayer Certainty and Disaster Relief Act of 2020, P.L. 116-260). The provision is effective for distributions made after December 31, 2023.

K. Early Withdrawal Penalties

- **e. Elimination of 10% additional tax on corrective distributions of excess contributions**. The act provides that earnings attributable to excess contributions to an IRA that are returned by the due date for the taxpayer's return for the year (including extensions) are exempt from the Sec. 72(t) 10% additional tax.

K. Early Withdrawal Penalties

- **3. Tax on excess contributions to certain tax-favored accounts and annuities**
- a. The 6% excise tax on excess contributions is a tax, not a penalty, and, consequently, no written supervisory approval was necessary, (See Coutrier v. Comm., TX Memo 2024-6).
- b. Does SECURE 2.0 establish a finite statute of limitation barring the collection of the excess contribution tax ?
- i. The Act provides that the filing of an income tax return on Form 1040 will start the running of a six-year statute of limitation, even if no Form 5329 is filed.
- ii. However, there is no retroactive feature associated with the passage of SECURE 2.0 and excess contributions occurring prior to 2022. ((See Coutrier v. Comm., TX Memo 2024-6).

SECTION IV:

STANDARD DEDUCTIONS AND ITEMIZED DEDUCTIONS

I. Standard Deductions

A. 2024 Thresholds - Rev. Rul. 2023 – 34

- 1. For 2024, the basic standard deduction will be:
  - Joint return or surviving spouse $29,200
  - Single (not head of household or surviving spouse) $14,600
  - Head of household $21,900
  - Married filing separate returns $14,600

- 2. For an individual who can be claimed as a dependent on another's return, the basic standard deduction for 2024 will be $1,300, or $450 plus the individual's earned income, whichever is greater. The standard deduction may not exceed the regular standard deduction for that individual.

A. 2024 Thresholds - Rev. Rul. 2023 – 34

- 3. For 2024, the additional standard deduction for married taxpayers 65 or over or blind will be $1,550. For a single taxpayer or head of household who is 65 or over or blind, the additional standard deduction for 2024 will be $1,950.

B. 2025 Thresholds –Rev Rul 2024 – 40

- 1. For 2025, the basic standard deduction will be:
  - Joint return or surviving spouse $30,000
  - Single (not head of household or surviving spouse) $15,000
  - Head of household $22,500
  - Married filing separate returns $15,000

- 2. For an individual who can be claimed as a dependent on another's return, the basic standard deduction for 2025 will be $1,350, or $450 plus the individual's earned income, whichever is greater. The standard deduction may not exceed the regular standard deduction for that individual.

B. 2025 Thresholds –Rev Rul 2024 – 40

- 3. For 2025, the additional standard deduction for married taxpayers 65 or over or blind will be $1,600. For a single taxpayer or head of household who is 65 or over or blind, the additional standard deduction for 2025 will be $2,000

C. Substitute Return and Standard Deduction

- 1. A taxpayer that did not file a return but allow the IRS or had the IRS prepared a substitute return does allow the taxpayer to take a standard deduction. However, a subsequent amended return claiming itemized deductions will be disallowed. Section 63 (e) (1) states that unless an individual makes an election no itemized deduction will be allowed for the tax year. Furthermore under Section 63 (e) (2) any election shall be made on the taxpayer's return and certain circumstances a taxpayers may change election with respect to itemized deductions but only when a return that was previously filed. A substituted return is not considered a previously filed return by the taxpayer. (See Salter v. Comm., TC Memo 2022 – 29)

II. Itemized Deductions

A. Medical Expenses

- **1. Standard Mileage Rate**

- **a. 2024**: The standard mileage rate for medical expenses is set at $0.21 per mile for 2024. (IR 2023 – 239)

- **2. 2024 Long Term Care Premium Limits - Rev. Proc. 2023 – 34**

A. Medical Expenses

Not more than 40	$470
More than 40 but not more than 50	$880
More than 50 but not more than 60	$1,760
More than 60 but not more than 70	$4,710
More than 70	$5,890

A. Medical Expenses

- **3. 2025 Long Term Care Premium Limits - Rev. Proc. 2024 – 40**

A. Medical Expenses

Not more than 40	$480
More than 40 but not more than 50	$900
More than 50 but not more than 60	$1,800
More than 60 but not more than 70	$4,810
More than 70	$6,020

A. Medical Expenses

- **4. Payments received under qualified long-term care insurance.**

- **a. 2024**. Amounts received under a qualified long-term care insurance contract are generally excludable as amounts received for personal injuries and sickness, subject to a per diem limitation, which will be $410 in 2024. (Rev. Proc 2023-34)

- **b. 2025**. Amounts received under a qualified long-term care insurance contract are generally excludable as amounts received for personal injuries and sickness, subject to a per diem limitation, which will be $420 in 2025. (Rev. Proc 2024 – 40)

- **5. Notice 2024 – 71: Condoms are Considered Qualified Medical Expenses**

A. Medical Expenses

- a. The IRS established a safe harbor for expenses for the purchase of condoms to be treated as a qualified medical expense. As such, those expenses can be reimbursed by a health flexible spending arrangement, a health reimbursement arrangement, or a health savings account.

- **6. IR 2023-47, new IRS FAQ and what constitutes deductible medical expenses.** The IRS has posted answers to FAQs about when certain costs related to nutrition, wellness and general health are deductible medical expenses paid or reimbursed under a health savings account, health flexible spending arrangement, Archer medical savings account, health reimbursement arrangement as well as deductible subject to the AGI limitation.

A. Medical Expenses

- a. To be deductible, the qualified medical expenses must be incurred primarily to alleviate or prevent a physical or mental disability or illness.

- b. Qualified medical expenses include the costs of diagnosis, cure, mitigation, treatment, or prevention of disease that affects any part or function of the body, as well as payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They also include costs for equipment, supplies and diagnostic devices, medicines and drugs that are prescribed by a doctor. Qualified medical expenses generally do not include expenses that are merely beneficial to general health.

A. Medical Expenses

- c. The IRS' new FAQs cover questions about whether the costs of items such as gym memberships, weight loss programs and special foods can be deducted as qualified medical expenses. For example,

A. Medical Expenses

- FAQ 9 says that the cost of weight-loss programs is deductible or reimbursable by a medical savings account when the program treats a specific disease i.e., obesity, diabetes, hypertension, or heart disease diagnosed by a doctor.
- FAQ 10 says that gym memberships are deductible but only when the membership is purchased for the sole purpose of affecting a structure or function of the body (i.e., a prescribed plan for physical therapy to treat an injury) or for the sole purpose of treating a specific disease (i.e., obesity, hypertension, or heart disease) diagnosed by a physician.
- FAQ 12 finds that the costs of food and beverage is deductible but only when (1) the food or beverage doesn't satisfy normal nutritional needs, (2) the food or beverage alleviates or treats and illness, and (3) the need for the food or beverage is substantiated by a doctor. In this case the medical expense deduction is limited to the amount by which the cost of the food or beverage exceeds the cost of a product that satisfies normal nutritional needs.
- FAQ 13 says that the cost of over-the-counter drugs and medicines generally can't be deducted as a medical expense. However, these costs (and menstrual care products) may be paid or reimbursed by a medical savings account.

A. Medical Expenses

- d. Qualified medical expenses generally do not include expenses that are merely beneficial to general health.

Example

- **PLR 202311001**. Taxpayer purchase food for their five month old infant based on doctor’s recommendation and taxpayer’s belief that such could reduce infants risk of developing certain medical conditions in the feature even though the child had no known illness caused by that condition nor imminent probability of one. As such the deduction for said food is a medical expense was denied.

A. Medical Expenses

- **7. IR 2024-65: Misrepresentation on General Health and Wellness Expense Deductions**. The IRS has issued an alert for taxpayers and health spending plan administrators to remember that personal expenses for general health and wellness are not considered medical expenses under the tax law. The warning came in response to aggressive marketing claims by some companies that misrepresent the circumstances under which food and wellness expenses can be paid or reimbursed under FSAs and other health spending plans. According to the IRS, notes from physicians that are solely based on self-reported data are insufficient as they fail to meet the requirement that the note be related to a diagnosis-specific activity or treatment. FSAs and other health spending plans that pay for, or reimburse, non-medical expenses are not qualified plans. If the plan is not qualified, all payments made to taxpayers under the plan, even reimbursements for actual medical expenses, are includible in income.

B. Taxes

- 1. The state and local income tax (SALT) deduction allows the tax reduction up to $10,000 ($5000 if married filing separately) for a combination of property taxes in either state and local income taxes or sales taxes. This continues to be in existence for 2025.

- **2. New York v. Yellin (US 4 – 18 – 22).** The US Supreme Court has declined to review an appellate case of the 2nd Circuit Court which upheld the $10,000 limit on the amount of state and local taxes (SALT) that can be claimed as a deduction on an individual income tax return. The suit was filed not only by the York but joined by Connecticut, Maryland and New Jersey. States sought to overturn the limitation on the basis of unconstitutionality indicating that the caps were targeted coercion against the states. The court did not address the states claim that the Limitation violated the 10th amendment and that he co-worst the states to abandon fiscal policies by either lowering their own taxes or cut spending.

B. Taxes

- 2. Taxpayer has the burden of proof to show state and local taxes were paid, the IRS cannot arbitrarily deny such amounts.

Example

- **Schneider v. Comm., TC Memo 2022 – 104.** Taxpayer was denied state and local tax deduction originally by the IRS despite the fact that having proven that the amount paid exceeded the standard deduction amount. The Tax Court indicated that the taxpayer is entitled to a deduction for state income taxes deducted on his W-2. That is all the substantiation that is required.

C. Interest Expense

- **1. Substantiation**

- a. Substantiation for interest expense requires the debt constituting acquisition and the debt must be associated with a qualified residence. In addition, the substantiation requirement also applies to mortgage insurance premium payments on a principal residence.

Examples

- **Tucker v, Comm., TC Memo 2023 – 87**. The taxpayers were denied interest expense deductions for property the husband owned as a joint tenant with an unrelated third party. The taxpayers produce Forms 1098 from various banks but did not substantiate husband in fact made said payments.

- **Shilgevorkyan v. Comm., TC Memo 2023-12**. The taxpayer was not entitled to mortgage interest deduction regarding property which one of taxpayer's brother originally purchased and taxpayer alleged a half interest in upon taxpayer's acquisition another brother. Taxpayer did not have legal title to property because brother from whom he allegedly purchased his interest was only accommodation party to construction loan and did not himself have interest to transfer to taxpayer. Taxpayer also did not hold equitable title. Taxpayer did not show that property qualified as his principal residence for these purposes in year at issue, during which he stayed at and listed another property as his residence

C. Interest Expense

- b. Substantiation also requires that the mortgage company applying the payment.

Example

- **Howland, Jr., et ux. v. Comm., TC Memo 2022 – 60**. The taxpayers were a married couple and were denied mortgage interest expense deduction on their home for the year in which they had multiple loans secured by principal residence that was sold at foreclosure sale to bank. The bank in turn sold the residence to 3parties. The taxpayers argued that funds which bank received were to be applied to their outstanding interest before principal. However, they failed to show how bank in fact applied same and whether they had any remaining principal balance.

D. Charitable Contributions

- **1. Standard Mileage Rate**. The standard mileage rate is $.14 per mile for use of an automobile in services to a charitable organization. (Notice 2023 – 3)

- **2. Required Documentation for Charitable Contributions – Publication 1771**

D. Charitable Contributions

- a. The IRS imposes recordkeeping and substantiation rules on donors of charitable contributions and disclosure rules on charities that receive certain quid pro quo contributions.
  - Donors must have a bank record or written communication from a charity for any monetary contribution before the donors can claim a charitable contribution on their federal income tax returns.
  - Donors are responsible for obtaining a written acknowledgment from a charity for any single contribution of $250 or more before the donors can claim a charitable contribution on their federal income tax returns.
  - Charitable organizations are required to provide a written disclosure to a donor who receives goods or services in exchange for a single payment in excess of $75.

D. Charitable Contributions

- b. A donor cannot claim a tax deduction for any contribution of cash, a check or other monetary gift unless the donor maintains a record of the contribution in the form of either a bank record (such as a cancelled check) or a written communication from the charity (such as a receipt or letter) showing the name of the charity, the date of the contribution and the amount of the contribution.

- c. For charitable contributions made by payroll deduction, the donor may use a pledge card prepared by or at the direction of the charitable organization, along with one of the following a pay stub, Form W-2, Wage and Tax Statement, or other employer-furnished document that shows the amount withheld and paid to a charitable organization.

- d. If a donor makes a single contribution of $250 or more by payroll deduction, the pledge card or other document from the organization must also include a statement to the effect that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction.

D. Charitable Contributions

- e. Each payroll deduction amount of $250 or more is treated as a separate contribution for purposes of the $250 threshold requirement for written acknowledgments.
- f. Written Acknowledgment. A donor cannot claim a tax deduction for any single contribution of $250 or more unless the donor obtains a contemporaneous, written acknowledgment of the contribution from the recipient organization. An organization that does not acknowledge a contribution incurs no penalty; but, without a written acknowledgment, the donor cannot claim the tax deduction. Although it's a donor's responsibility to obtain a written acknowledgment, an organization can assist a donor by providing a timely, written statement containing:

D. Charitable Contributions

- i. the name of organization,
- ii. the amount of cash contribution,
- iii. a description (but not the value) of non-cash contribution,
- iv. a statement that no goods or services were provided by the organization in return for the
- contribution, if that was the case,
- v. a description and good faith estimate of the value of goods or services, if any, that an
- organization provided in return for the contribution,
- vi. a statement that goods or services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits (described later in this publication), if that was the case.

D. Charitable Contributions

- g. A separate acknowledgment may be provided for each single contribution of $250 or more, or one acknowledgment, such as an annual summary, may be used to substantiate several single contributions of $250 or more. Letters, postcards or computer-generated forms with the above information are acceptable. An organization can provide either a paper copy of the acknowledgment to the donor, or an organization can provide the acknowledgment electronically, such as via an email addressed to the donor.. Separate contributions of less than $250 will not be aggregated. An example of this could be weekly offerings to a donor’s church of less than $250 even though the donor’s annual total contributions are $250 or more.

D. Charitable Contributions

- h. For the written acknowledgment to be considered contemporaneous with the contribution, a donor must receive the acknowledgment by the earlier of the date on which the donor actually files his or her individual federal income tax return for the year of the contribution; or the due date (including extensions) of the return.

- i. The acknowledgment must describe goods or services an organization provides in exchange for a contribution of $250 or more. It must also provide a good faith estimate of the value of the goods or services because a donor must generally reduce the amount of the contribution deduction by the fair market value of the goods and services provided by the organization. Goods or services include cash, property, services, benefits or privileges.

- j. If a donor makes a single contribution of $250 or more in the form of unreimbursed expenses, for example, out-of-pocket transportation expenses incurred to perform donated services for an organization, then the donor must obtain a written acknowledgment from the organization containing a:

D. Charitable Contributions

- Description of the services provided by the donor
- Statement of whether the organization provided goods or services in return for the contribution
- Description and good faith estimate of the value of goods or services, if any, that the organization provided in return for the contribution
- Statement that goods or services, if any, that the organization provided in return for the contribution consisted entirely of intangible religious benefits.

All Summary of Required Documentation for Charitable Deductions

Type	Documentation
Single cash contribution of less than $250	Cancelled check, bank record, credit card statement, or written acknowledgment from the charity. Sec.170(f) (17); IR-2006-192
Single cash contribution of $250 or more Payroll deduction	Written acknowledgment from the charity. Sec.170 (f)(8) Pledge card and W-2, paystub, etc. Sec.1.170A-13(c); Notice 2008-16
Noncash contributions less than $250	Written acknowledgment from the charity or other reliable record. Sec.1.170A-13(b)(1)
Noncash contribution of $250 but not more than	Written acknowledgment from the charity$ 500 1.170A-13(b)(3)

All Summary of Required Documentation for Charitable Deductions

Type	Documentation
Noncash contribution over \$500 under \$5,000	Written acknowledgment from the charity and Form 8283, part A. Sec.1.170A-13(b)(3)
Noncash contribution of >\$5,000	Written acknowledgment from the charity, appraisal and Form 8283, part B. Sec.170(f)(11)(c)
Noncash contribution > \$500,000	Written acknowledgment from the charity, appraisal, and Form 8283, part B. Attach appraisal to the return.Sec.170(f)(11)(D)
Noncash contribution of auto, boat, or airplane with a value of \$ 500 or more	Written acknowledgment from the charity.

All Summary of Required Documentation for Charitable Deductions

Type	Documentation
	Attach Form1099-C and for 8283 Sec.170(e)(11)(c); IR-2006-192
Noncash contribution of publicly traded stock	Written acknowledgment from the charity and Form 8283, part A. Sec.1.170A-13 (c)(7)(xi)(B)
Noncash contribution of privately traded stock > $ 5,000	Written acknowledgment from the charity, and Form 8283-part B. If the privately traded stock is valued at $10,000 or more, attach an appraisal to the return.Sec.1.170A-13 (c)(2)(ii)(B)(1)
Noncash contribution of art valued at more than $20,000	Written acknowledgment from the charity, appraisal, Form 8283, part B. Appraisal and a photo of the art must be attached to the return. Rev. Proc. 96-15

Examples

- **Tucker v. Comm., TC Memo 2023-87**. Taxpayers were not entitled to charitable contribution deduction above amount IRS allowed for cash donation to church. The taxpayers failed to satisfy the contemporaneous written acknowledgement requirement for cash donations greater than $250. The each written communication from church did not indicate whether church provided any goods or services in consideration for wife's purported contribution.

Examples

- **Braen et al v. Comm., TC Memo 2023-85**. In consolidated cases involving a bargain sale transaction, taxpayers through their S Corporation were involved in zoning litigation. Subsequently, taxpayers contributed on developed land to a charity in settlement of the litigation. The Tax Court determined the taxpayers failed to show the value of all consideration received as part of the sale and were not entitled to their proportionate share of charitable deductions. The taxpayers argued the bargain sale was made with donative intent however, contemporaneous written acknowledgments did not include description and good faith estimate of any goods or services received in exchange. The S Corp. did receive acknowledgment letters but failed to state any goods or services were received in exchange.

D. Charitable Contributions

- **3. IR 2023 – 185: Danger of Improper Art Work Donation Deductions**. The Service has issued information release caution taxpayers to be on the alert for promotions involving exaggerated artwork donation deductions. The basic scheme is for promoters to encourage taxpayers to buy artwork at a discounted price while promising that the art is worse and typically more than the purchase at the discounted price. The promoters encourage purchasers to purchase the artwork hold it for a year and then claim a charitable contribution upon a transfer to a valid charity. In essence the deduction would be an inflated fair market value. The IRS in the notice warns taxpayers about such schemes and that a qualified appraisal is still a requirement to be associated with the contribution.

D. Charitable Contributions

- **4. Donative Intent Required for Charitable Contribution – 20233201 F**. The chief counsel determined that a taxpayer could not claim a charitable contribution deduction because they did not intend to make a gift and there was nothing of value to contribute once the taxpayer sold the property in a bargain for exchange. In this situation the taxpayer had received an offer from Y to purchase property. Y made a substantial payment to the taxpayer. Subsequently the parties could not agree on a price and there were multiple appraisals of the property. The parties wound up in litigation and a settlement was reached where the parties acknowledge they had disagreements on the fair market value. In the end, the taxpayer accepted Y’s initial offer for the property.

D. Charitable Contributions

- The taxpayer claimed a charitable deduction for a bargain sale to Y which was a charity. The taxpayer deducted as a charitable contribution at amount equal to the difference between the appraised value the property and the amount the charity paid for the property. The chief counsel noted that after the parties had signed the settlement agreement, the taxpayer had no further rights in the property so it could not be allowed to attribute additional value to the property by way of a tax deduction on top of what had already been deemed. The chief counsel found that the difference between the charities payment and he prays that the property was not a charitable donation because the taxpayer had rejected the offer and had not intended to make a gift by rejecting the offer. Although the charity ultimately acquired the property, the taxpayer could not substantiate its claim chart will contribution deduction because it could not prove the fair market value of the property. The Form 8283 did not acknowledge the fair market value of the donated property and the charity never acknowledge that the property had value above the amount it offered at the time of purchase.

D. Charitable Contributions

- **5. Qualified appraisal and other documentation for certain contributions**

- a. In the case of an individual, partnership, or corporation, no deduction shall be for any contribution of property for which a deduction of more than $500 is claimed unless such person meets the requirements with respect to such contribution.

D. Charitable Contributions

- b. In the case of contributions of property for which a deduction of more than $5,000 is claimed, the requirements of this subparagraph are met if the individual, partnership, or corporation obtains a qualified appraisal of such property and attaches to the return for the taxable year in which such contribution is made such information regarding such property and such appraisal as the Secretary may require.

D. Charitable Contributions

- c. Qualified Appraisal Requirement

- i. A qualified appraisal is an appraisal document prepared by a qualified appraiser in accordance with generally accepted appraisal standards. These standards include:

- **ii. A qualified appraisal must include: (See Reg. Sec. 1.170A-17)**

D. Charitable Contributions

- Information about the contributed property, including a description in sufficient detail under the circumstances, taking into account the value of the property, that a person not generally familiar with the type of property can ascertain that the appraised property is the contributed property.
- In the case of real property or tangible personal property, the condition of the property.
- The valuation effective date, which must be no earlier than 60 days before the date of the contribution and no later than the due date, including extensions, of the tax return on which the deduction for the contribution is first claimed.
- The date, or expected date, of the contribution, not be earlier than 60 days before the date of the contribution and no later than the date of the contribution.
- The fair market value of the contributed property on the valuation effective date.

D. Charitable Contributions

- iii. The qualified appraiser must possess the required education and experience in valuing the type of property including successfully completing professional or college coursework in valuing the type of property pursuant to the appraisal, or earn a recognized appraisal designation.

- d. Exceptions to the substantiation can include a reasonable cause as to the lack of the documentation and not willful neglect.

Examples

- **Bass v. Comm., TC Memo 2023 – 41**. The taxpayer made non-cash contributions to Goodwill, and the Salvation Army. The taxpayer attached Form 8283 indicating appraised values of 10,002 86 and the amount for purchase for $4360. On Section B of the form the taxpayer indicated he donated the properties including use condition. The taxpayer argued he made a total of 173 trips and received donation acknowledgment receipts for each trip. The taxpayer testify that because the donated items reflected each trip at a fair market value less than $250 he did not need to have a qualified appraisal. Qualified appraisal applies to any and all similar items of property donated to one or more charities. Obviously since the amount exceeded $5000 he was required to get an appraisal and failed to do so.

Examples

- **Hoensheid v. Comm., TC Memo 2023-24**. Taxpayers had contributed appreciating stock in a closely held corporation to a charitable organization that administered a donor advised fund. The contribution was denied for failing to meet the qualified appraisal requirement. Specifically, the appraisal did not sufficiently describe the qualifications of the appraiser, experience of the appraiser and stated incorrect contribution date. The taxpayers could not sure reasonable cause exception since they use financial services manager as the appraiser despite knowing the lack of experience the appraiser had with respect to the matter at hand.

Examples

- **Lim & Chu v. Comm., TC Memo 2023 – 11**. The taxpayers reported a non-cash charitable contribution deduction of over $1.6 million passing through to them from a pass-through entity created under tax scheme. The contribution amount exceeded the maximum allowable deduction. The taxpayers claiming $1.2 million deduction for the tax year and carried the balance forward to the next tax year. Section 170 (f) (11) disallows a deduction for certain non-cash charitable contributions unless specified substantiation documentation requirements are met. In this case of a contribution of property value in excess of $500,000, the taxpayer must obtain attached to the return a qualified appraisal. Qualified appraisal submitted could not be qualified because the appraiser prepared it in exchange for a prohibited appraisal fee. The prohibited appraisal fee was a percentage of the deductible amount up to $1 million plus an additional percentage of the deductible amount of assets exceeding $1 million in other words of sliding contingency fee. Furthermore, the appraiser was the individual who set up the tax scheme to begin with and that is also disallowed.

Examples

- **Izen v. US 38 F4th 459 (5TH Cir 2022.).** The Fifth Circuit upheld the Tax Court's decision that the taxpayer was not entitled to a charitable contribution deduction for the donation of his 50% interest in an aircraft to an aeronautical heritage society because he did not provide a contemporaneous written acknowledgment. For a donation of a qualified vehicle, including an airplane, the value of which exceeds $500, the taxpayer must provide a contemporaneous written acknowledgment from the donee organization of the contribution, including the donor's name and TIN. An acknowledgment is contemporaneous if the charitable organization provides it within 30 days of the contribution. Additionally, the recipient organization must provide the IRS with the information contained in the acknowledgment. With his 2010 Form 1040-X the taxpayer, J provided a letter from the donee organization, but it was addressed to Philippe Tanguy, not Izen. Also, the letter did not mention Izen or include his TIN. Izen also submitted a copy of a donation agreement between him, Tanguy, and the society, but it, too, lacked his TIN.

Examples

- Finally, although Izen attached Form 8283 to his Form 1040-X, the Form 8283 did not include his TIN and was not signed contemporaneously. Izen argued that he substantially complied with the rules and that the documents he submitted should be read together with his tax return to support the claimed deduction. The court denied the substantial-compliance argument because the doctrine of substantial compliance applies to a failure to meet a regulatory requirement, not a statutory requirement. Thus, taxpayers must strictly follow the documentation requirements set out by Congress in the statute to qualify for the charitable contribution deduction.

D. Charitable Contributions

- **e. Qualified Appraisal Required to Deduct Charitable Contributions of Cryptocurrency – CCA 202302012**. The Service disallowed taxpayers charitable contribution deduction of more than $5000 of crypto current because the taxpayer failed to obtain a qualified appraisal of the donated crypto. The taxpayer's reliance on the crypto current is he exchange value of the donated property is not a reasonable cause for not obtaining an appraisal. The Service indicated that the taxpayer must satisfy the substantiation requirements and that Crypto current is viewed as a non-cash charitable contribution. It is not deemed to be a readily valued property like cash, publicly traded securities, intellectual properties and certain vehicles. In addition, the form 8283 was not completed properly to even allow for a reasonable cause exception.

D. Charitable Contributions

- **6. Conservation Easements**

- a. Taxpayers can take a charitable deduction for qualified conservation contributions, which are contributions of a qualified real property interest to a qualified organization exclusively for conservation purposes (See Section 170(h)(1)).

- b. A qualified real property interest for this purpose can be the taxpayer's entire interest in the property, a remainder interest or an easement that restricts the use of the property in perpetuity.

D. Charitable Contributions

- c. Conservation purposes under IRC Section 170(h)(4)(A) are as follows:
  - preserving land for outdoor recreational use by, or education of, the general public;
  - protecting relatively natural habitats of fish, wildlife or plants;
  - preserving open space (including farmland or forest space) for scenic enjoyment of the general public or under a governmental conservation policy yielding significant public benefit; and
  - preserving a historically important land area or a certified historic structure.

- d. Retain Surface Mining Rights in Conservation Easement

D. Charitable Contributions

- **i. North Donald La Property, LLC v. Comm., TC Memo 2023-50**. The LLC filing as a partnership was denied a charitable contribution deduction for the conveyance of a conservation easement to a land Conservancy. The service argued that the limited warranty deed gave the former owners of the land over which the easement was granted a right to my subsurface clay. The owners claim that they intended to transfer all rights to access and exploit the clay reserving rights only to 75% of subsurface liquid and gaseous materials. The taxpayers argued further that even if there was evidence of the retention of rights they had relinquished such in an amended deed in which they relinquished to the LLC any right they had in the minerals located on the land including the clay. However, the amended deed indicated that such relinquishment could be withdrawn at any time.

D. Charitable Contributions

- **ii. CCA 202236010**. The chief counsel advisory indicated that the conservation easement does not satisfy the exclusive purpose of conservation or exclusively for conservation purposes when the terms of the deed allow the donor to use a surface mining method to extract subsurface minerals with the donee's approval. The only way that the easement is exclusively for conservation purposes is that the conservation is protected permanently, the chief counsel advisory found that because the donor had a retained qualified mineral interest the donor will be allowed to extract or remove minerals from the surface thus potentially destroying the conservation.

D. Charitable Contributions

- **e. Perpetuity Issues and Conservation Easement Extinguishments**. Section. 170(h)(1) allows a charitable contribution deduction for the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A contribution is not exclusively for conservation purposes unless that purpose is protected in perpetuity.

- i. If, after the creation of the easement, an unexpected event occurs that makes the continued use of the property for conservation purposes impossible or impractical, the conservation purpose can be treated as protected in perpetuity if the restrictions on the property are extinguished by a judicial proceeding and the donee uses all of its proceeds from any disposition of the property in a manner consistent with the original contribution.

D. Charitable Contributions

- ii. Under Regs. Sec. 1.170A-14(g)(6)(ii)a donee must receive a minimum amount of the proceeds from a future disposition. At the date of the donation, the donor must agree that the donee has a property right that has a value at least equal "to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time." That proportionate value must remain constant, and upon a subsequent disposition by judicial decree or a condemnation, the donee must be entitled to a share of the proceeds at least equal to that proportionate value.

- **f. Valuation Issues and Substantiation**. Amount of Charitable Contribution Deduction did not equal easements fair market value because property contributed was inventory noninvestment.

Examples

- **JL Minerals, LLC v. Comm., TC Memo 2024 – 93**. The taxpayer a partnership contributed a conservation easement on stated acres of real property. The Tax Court rejected the IRS's argument that the deduction is not allowable because the primary purpose of the donation was to obtain tax savings and did not carry daunted intent. The services position was unfounded and contrary to the fact that motivation wasn't determine it. The partnership provided sufficient appraisal and information for the deduction. The partnerships charitable donation of the conservation easement was exclusive for conservation purposes the easement protected plant communities and ecosystems natural to the county in a relatively natural state. The easement did reserve certain rights those rights were tied to enforceable restrictions presenting inconsistent use with the conservation purpose. The appraisal met the rules on being qualified and was a qualified appraisal the court found that while the appraisal was not perfect in nature it met the requirements under Section 170 (f) (11) and that reasonable persons with partnership knowledge would expect the appraiser's not to overvalue the easement in nature.

Examples

- **Corning Place Ohio, LLC v. Comm., TC Memo 2024 – 72**. Charitable deduction for a tiered partnerships donation of conservation easement on renovated historic office building the Tax Court determined the deduction was not allowable the partnership did not make the contribution in the tax year at issue as required. Rather, the partnership made the donation at the time when it was a single member LLC that was disregarded before the start of the tax year for which it filed as a partnership. The single member LLC was the correct party to report the contribution.

Examples

- **Buckelew Farm, LLC v. Comm., TC Memo 2024 – 52**. The partnership was entitled to a charitable contribution deduction for its donation to a tax exempt organization of a conservation easement. The Service had argued that the easement failed to provide the organization a proportionate share of the extinguishment proceeds as required under the regulations. The Court of Appeals for the 11th circuit in Hewitt v. Commissioner (21 F 4RG 1336) held that treasury regulation 1.170A – 14 (g) (6) (ii) was arbitrary and capricious and ruled to be invalid. The tax court rejected the IRS's argument that the easement fails to provide the organization a proportionate share of the extinguishment proceeds. The taxpayer had daunted intent when it made the contribution. The Service argued that the trouble contribution was made only for personal profit of the managers by enticing potential investors with a tax deduction for the conservation easement.

Examples

- The IRS also argued that the easement deal was priced so the investors would substantially have savings that exceeded the amount of the contribution. The Service also argued without merit that the appraisal was not a qualified appraisal under the code. The Tax Court found that argument unpersuasive stating that a before value determination provided by the IRS's expert was based on comparable vacant sales and did not pertain to the matter at hand.

Examples

- **Savannah Shoals , LLC v. Comm., TC Memo 2024 – 35**. The partnership was entitled to a charitable contribution deduction for the donation of an easement. The Service argued that the taxpayer was not entirely deduction because it failed to satisfy the height substantiation requirements applicable to non-cash charitable deductions. The appraisal provided sufficient information for the IRS to evaluate the deduction. The IRS argued that the appraised value was the wrong asset and that the appraised value of the property was that of the subsurface not the easement. The appraisal correctly indicated that it was an appraisal of an easement. The appraisal include a sufficient description of the donated property for a person who was not generally for me with easements to ascertain its proper value.

Examples

- Though the appraisal did not strictly comply with the qualified appraiser requirements, it provided enough information for the IRS to evaluate. The Tax Court found that the taxpayer’s experts over estimated annual sales of aggregated sales from the proposed quarry and overstated potential profitability. In other words, while the valuation did pertain to the easement from a methodology perspective it was slightly overvalued in terms of being valued at investment value and not fair market value. The court adjusted it accordingly. Specifically, the court allowed a conservation easement deduction of $480,000 based upon the appraisal and not the 23 million as claimed by the taxpayer partnership. The court rejected the IRS determination that nothing should be awarded because the appraisal sales projections were optimistic. Optimism is not a criteria to automatically exclude an appraisal.

Examples

- **Valley Park Ranch, LLC v. Comm., 162 TC No. 6 Dec. 62, 442**. The Tax Court has ruled against the IRS's denial of a conservation easement deduction by declaring a Treasury regulation to be invalid under the enactment requirements of the Administrative Procedure Act. An LLC conveyed a conservation easement of land to a foundation that was properly registered with the county clerk. The deed conveyed the easement in perpetuity, allowing for extinguishment only in cases where the conservation purposes became impossible to accomplish or if the property were to be condemned by the local government through eminent domain. The LLC then timely filed Form 1065, U.S. Return of Partnership Income, claiming a $14.8 million deduction under Section 170 (h) for conveyance of the easement, and included with the return Form 8283.The IRS disallowed the deduction stating the conservation purpose of the easement was not "protected in perpetuity" this in fact was not the case. In essence, the Tax Court agreed with the 11th circuit Court of Appeals invalidating the IRS regulation as opposed to the sixth circuit Court of Appeals that indicated the regulation was valid.

Examples

- **Excelsior Aggregates, LLC v. Comm., TC Memo 2024 – 60**. The charitable contribution deduction claim for conservation easements taken by a partnership were not entitled to be allowed as a viable tax deduction deductions. business with a track record of income, expenses, profits and growth rates. A historical track record provided real-world inputs that supply a plausible basis for projecting future revenue. The record showed that other properties relatively close to the subject properties were bought and sold over a ten-year period at prices that generally were lower. Given this evidence, it was wholly implausible that a hypothetical willing buyer with knowledge of the relevant facts would purchase them for the prices determined by the taxpayer's expert. Further, regarding the third parcel of the subject property the Tax Court found the taxpayer's expert's valuation method to be the more reasonable approach. The taxpayer's expert conducted his comparable sales analysis in a manner appropriately tailored to the noncontiguous nature of the parcel. Accordingly, the fair market value of the fee simple interest in the property was correctly determined by the taxpayer's expert.

Examples

- **Oconee Landing Property, LLC v. Comm., TC Memo 2024 – 25**. The taxpayer, and LLC filing as a partnership, was entitled to a charitable contribution deduction of zero because it failed to secure and attached to his return a qualified appraisal of the contributed property. The property in question included a conservation easement. The partners who controlled the taxpayer had knowledge of facts that would cause a reasonable person to expect the appraiser falsely overstate the value of the donated property. There were eight intermediaries between the taxpayer and the appraisers who ensured that all information was passed back and forth across the chain. The appraiser's final appraisal that was included the return was not a qualified appraisal. It appears the taxpayer's partners and associates create dozens of distinct entities to conduct their real estate activities. These include holding companies, development companies, investment companies. Deterring the tax character of the parent tract, it was if material of which these entities ultimately perform the development and construction work.

Examples

- The parent tract which was the subject of the conservation easement and contribution was at all times ordinary income property. Any charitable contribution deduction attributable to the taxpayer's grant of a conservation easement was limited to the taxpayer's basis in the property at the time of the donation. The taxpayer supplied no evidence to establish the starting point for the calculation of basis. In other words, the taxpayer failed to prove its entitlement to deduction in excess of zero because they failed to prove that there was basis in the property exceeding zero.

Examples

- **Carter v. Comm., TC Memo 2023 – 133**. Taxpayers took charitable contribution deductions for partnership donations to a land trust of an easement. The Tax Court found the documentation and protection perpetuity requirements were met. The easement was qualified real property in the taxpayers were in town the deductions equal the fair market value the easements at the time of the contribution. The value of the easement was lowered due to a methodology issue as there was a lack of demonstration that the value was unique in nature to warrant a higher valuation.

H. IRS Has Burden of Proving Lack of Reasonable Cause Regarding Contemporaneous Written Acknowledgment.

Examples

- **Murfam Enterprises LLC v. Comm., TC Memo 2023 – 73**. The taxpayer donated an easement to a qualified organization for a conservation. The land subject to the easement had been granted hog farming certificates by the state. The taxpayer claimed a charitable contribution deduction supported by an appraisal of the donated property. The appraisal value the property based on the foregone value of the hog farming certificates attached to the property. The Form 8283 did not include the taxpayer’s basis in the land and was viewed is incomplete. he IRS reduced the deduction on the premise that the value of the hog-farming certificates was zero and the easement should have been valued according to the land’s use as timberland.

Examples

- The taxpayer filed a petition in Tax Court asking the court to review the IRS's determination. In its response to the taxpayer's petition, the IRS made a new assertion that the deduction should be entirely disallowed because the taxpayer did not comply with the substantiation and reporting requirements when it failed to attach a fully completed appraisal summary to Form 8283. The taxpayer claimed reasonable cause on this aspect, citing reliance on its CPA. The court held that while Murfam did in fact fail to strictly or substantially comply with the reporting requirements of Sec. 170(f)(11), the IRS did not meet its burden of proof to show a lack of reasonable cause. Thus, the charitable contribution deduction was not entirely disallowed. The parties still disagreed as to the value of the easement and the amount associated with the deduction. The court considered the value of the forgone hog-farming certificates and redetermined the easement's value as only slightly lower than what the taxpayer had originally claimed.

Examples

- **Murphy Jr. v. Comm., TC Memo 2023 – 72**. Taxpayers made charitable donations through an S corporation of conservation easements on lands and tracts that included a golf course. The Tax Court determined that none of the Form 8283 reported the basis in the contributed property as such the taxpayers did not meet the substantiation and reporting requirements. The Service has the burden of proving lack of reasonable cause as to the taxpayers omission of basis. The IRS never challenged it and did not challenge it at trial. The easements were found to protect a conservation purpose in perpetuity despite the fact that there were rights reserved by the donor nor. However, those reserve rights were subject to the approval by the charity. The deductions were allowed.

h. IRS Has burden of Proving Lack of Reasonable Cause regarding Contemporaneous Written Acknowledgment.

- **7. Final Regulations on Syndicated Conservation Easement Transactions – TD 10007**

- a. The IRS issued final regulations that identified certain abusive syndicated conservation easement transactions and substantially similar ones as reportable listed transactions. The final regulations clarify that participants and material advisers must report these transactions to the IRS, including any transactions that were completed in tax years that are still open.

- b. The final regulations cover three major classes of abusive syndicated conservation easement transactions
  - Those that involve contributions occurring before December 30, 2022;
  - Those for which a charitable contribution deduction is not automatically disallowed by Section 170(h)(7); and
  - Those that substitute the contribution of a fee simple interest in real property for the contribution of a conservation easement.

h. IRS Has burden of Proving Lack of Reasonable Cause regarding Contemporaneous Written Acknowledgment.

- c. The final regulations retain the 2.5 times rule with respect to the meaning of substantially similar transactions. Specifically, this is a bright line rule whereby transactions involving the promotional materials that offer investors the possibility of being allocated a charitable contribution deduction of anything less than 2.5 times a taxpayers investment generally are not substantially similar to the listed transaction in the final regulations.

- d. The definition of "conservation easement" is modified to provide that it is a restriction, within the meaning of Section 170(h)(2)(C), granted in perpetuity, on the use that may be made of the specified real property, exclusively for conservation purposes, within the meaning of Sections 170(h)(1)(C) and (h)(4).

- e. The final regulations also modify the definition of "participant" to clarify that the class of participants includes participants in transactions that are the same as, or substantially similar to, syndicated conservation easement transactions.

E. Casualty Losses

- 1. The Further Consolidated Appropriations Act of 2020 provides special rules for qualified personal casualty and disaster -related relief. Specifically, if the taxpayer has a net disaster loss the amount of the deduction equals the sum of the net disaster loss and the excess that exceeds 10% of the taxpayers AGI using a floor of $500.

- 2. The Tax Cuts and Jobs Act provides that a taxpayer may claim a personal casualty loss only if the loss is attributable to a presidentially declared disaster area. This is still in play until the year 2025.

- 3. Automatic Extension of Filing Deadlines in Case of Individual Taxpayers Affected by Federally Declared Disasters (§7508A; Appropriations Act, Sec. 205, pg. 712) Automatic 60-day extension. In the case of any qualified taxpayer, a mandatory 60-day extension has been added to the one-year waiver of taxes and interest option that may be granted by the Secretary of Treasury.

E. Casualty Losses

- 4. A qualified taxpayer includes:
  - An individual whose principal residence is in the disaster area,
  - Any taxpayer if the principal place of business (other than the employee) is located in a disaster area,
  - A relief worker assisting in a disaster area who is affiliated with a government or philanthropic organization,
  - A taxpayer whose records show necessity to meet certain deadlines by reason of a Presidentially declared disaster or terrorist or military actions,
  - Any individual visiting a disaster area who was killed or injured as a result of the disaster, and
  - Solely with respect to filing a joint return, any spouse of the above-mentioned individual.

- **5. CAA2021 Provides New Disaster Relief (HR 133).** The provisions of the Taxpayer Certainty and Disaster Tax Relief Act of 2021 (included in CAA2021) contained in the appropriations bill extend disaster relief for those in a qualified disaster area in 2021. In addition, the Act extends certain disaster relief provisions from the 2019 SECURE Act into 2022 and 2023.

- 6. This IRS webpage contains information to help taxpayers and tax practitioners with common tax-related questions after a disaster. A few highlights from the 38 FAQs follow:

E. Casualty Losses

- Disaster relief applies to the clients of tax preparers who are unable to file returns or make payments on behalf of the client because of a federally declared disaster. If the taxpayer is outside of the disaster area, he or she may qualify for relief if the preparer is in the federally declared disaster area and the preparer is unable to file or pay on the taxpayer’s behalf.
- If an affected partnership or S corporation cannot provide the taxpayer with the records necessary to file his or her return, then the taxpayer is an affected taxpayer. Filing and payment deadlines are postponed until the end of the postponement period just like the affected partnership or S corporation.
- If a taxpayer properly claimed a casualty loss deduction on an original return and in a later year receives reimbursement for the loss, the taxpayer does not amend the original return. Instead, the taxpayer should report the amount of the reimbursement in gross income in the tax year in which the reimbursements were received, to the extent the casualty loss deduction reduced their income in the tax year that the taxpayer reported the casualty loss deduction.
- The IRS will not abate interest on balances due on liabilities for prior years.
- The IRS will consider waiving late payment penalties when the reason for the late payment is due to reasonable cause related to the disaster.

Example

- **Richey v. Comm ., TC Memo 2023 – 43**. The Tax Court held that the IRS properly denied a $740,000 thousand loss deduction for damages to vacation on the boat with the taxpayer claimed the casualty was caused by a storm. The taxpayer failed to prove the damage was caused by the storm and more importantly it was not in a federally declared disaster area.

E. Casualty Losses

- **7. Texas Relief for Storm Victims – IRS News Release TX 2024 – 13.**

- a. The IRS has announced relief for individuals and businesses affected by severe storms, straight-line winds, tornadoes, and flooding that began on 4/26/24 in Calhoun, Collin, Cooke, Denton, Eastland, Guadalupe, Hardin, Harris, Jasper, Jones, Lamar, Liberty, Montague, Montgomery, Polk, San Jacinto, Trinity, Walker, and Waller counties.

- b. These taxpayers now have until November 1, 2024 to file various federal returns and make payments that were due on or after April 26, 2024 and before November 1, 2024. The November deadline also applies to quarterly estimated tax payments normally due on June 17, 2024 and September 16, 2024, and the quarterly payroll and excise tax returns normally due on April 30, 2024, July 31, 2024 and October 31, 2024.

- c. In addition, penalties on payroll and excise tax deposits due on or after April 26, 2024 and before May 13, 2024 will be abated if the deposits were made by May 13, 2024.

F. Miscellaneous Itemized Deductions Suspended

- **1. Beginning in 2018**

- a. For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for miscellaneous itemized deductions that are subject to the 2% floor are suspended. This does include the deduction for tax preparation expenses. The 2018 Schedule A has been revised to eliminate these miscellaneous itemized deductions that were subject to the 2% floor.

- b. This would also include miscellaneous itemized deductions subject to the 2% floor on Form 1041 as well.

F. Miscellaneous Itemized Deductions Suspended

- c. The deductions that would be subject to the 2% limitation are in three broad categories:
  - Unreimbursed Employee Expenses
  - Tax Preparation Fees
  - Other expenses which are generally on Schedule A, line 23

- d. On the IRS website, the service lists the following as unreimbursed employee expenses which would now appear in 2018 to be non-deductible:

F. Miscellaneous Itemized Deductions Suspended

- Business bad debt of an employee.
- Business liability insurance premiums.
- Damages paid to a former employer for breach of an employment contract.
- Depreciation on a computer your employer requires you to use in your work.
- Dues to a chamber of commerce if membership helps you do your job.
- Dues to professional societies.
- Educator expenses.
- Home office or part of your home used regularly and exclusively in your work.
- Job search expenses in your present occupation.
- Laboratory breakage fees.
- Legal fees related to your job.

F. Miscellaneous Itemized Deductions Suspended

- Licenses and regulatory fees.
- Malpractice insurance premiums.
- Medical examinations required by an employer.
- Occupational taxes.
- Passport for a business trip.
- Repayment of an income aid payment received under an employer's plan.
- Research expenses of a college professor.
- Rural mail carriers' vehicle expenses.
- Subscriptions to professional journals and trade magazines related to your work.
- Tools and supplies used in your work.
- Travel, transportation, meals, entertainment, gifts, and local lodging related to your work.
- Union dues and expenses.
- Work clothes and uniforms if required and not suitable for everyday use.
- Work-related education.

F. Miscellaneous Itemized Deductions Suspended

- e. The certain other expenses that are generally deductible Schedule A, line 23 generally refer to expenses that are ordinary and necessary and are paid to:
  - Produce or collect income that is generally included in gross income,
  - Manage, conserve or maintain property held for the production of income,
  - Determine, contest, pay or claim a refund of any tax

F. Miscellaneous Itemized Deductions Suspended

- f. These other expenses generally include the following:
  - Appraisal fees for a casualty loss or charitable contribution.
  - Casualty and theft losses from property used in performing services as an employee.
  - Clerical help and office rent in caring for investments.
  - Depreciation on home computers used for investments.
  - Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust.
  - Fees to collect interest and dividends.
  - Hobby expenses, but generally not more than hobby income.
  - Indirect miscellaneous deductions from pass-through entities.

F. Miscellaneous Itemized Deductions Suspended

- Investment fees and expenses.
- Legal fees related to producing or collecting taxable income or getting tax advice.
- Loss on deposits in an insolvent or bankrupt financial institution.
- Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed to you.
- Repayments of income.
- Repayments of social security benefits.
- Safe deposit box rental, except for storing jewelry, and other personal effects.
- Service charges on dividend reinvestment plans.
- Tax advice fees.
- Trustee's fees for your IRA, if separately billed, and paid

F. Miscellaneous Itemized Deductions Suspended

- **2. Miscellaneous Expenses not subject to the 2% limitation.**
  - Amortizable premium on taxable bonds.
  - Casualty and theft losses from income-producing property.
  - Federal estate tax on income in respect of a decedent.
  - Gambling losses up to the amount of gambling winnings.
  - Impairment-related work expenses of persons with disabilities.
  - Loss from other activities from Schedule K-1 (Form 1065-B), box 2.
  - Losses from Ponzi-type investment schemes.
  - Repayments of more than $3,000 under a claim of right.
  - Unrecovered investment in an annuity.

SECTION V:

QUALIFIED BUSINESS INCOME DEDUCTION

I. Qualified Business Income Deduction

A. Overview

- 1. Section 199A was enacted on December 22, 2017 under the Tax Cuts and Jobs Act (P. L. 115 – 97) and was subsequently amended on March 23, 2018 by the Consolidated Appropriations Act of 2018, (P. L.. 115 – 141).
- 2. This code section provides for a deduction to non-corporate taxpayers based on the concept of Qualified Business Income (QBI) in association with a Qualified Trade or Business.
- 3. Noncorporate taxpayers refer to individuals that operate a sole proprietorship or operate through a pass-through entity as well as certain estates and trusts.
- 4. Hence, the deduction may be taken by individuals and by some estates and trusts.

A. Overview

- 5. The deduction is not available for:
  - those that only possess wage income (Wages and Salaries),
  - those that have business income earned through a C Corporation.
  - a taxpayer that is a mere employee and has no ownership interest in a qualified trade or business.

- The deduction is available for a taxpayer who has not only wage income but also possesses ownership interest in a sole proprietorship or in a pass-through entity such as a partnership or S Corporation.

A. Overview

- 6. Section 199A allows individuals and some estates and trusts a deduction up to 20% of their combined qualified REIT dividends and qualified PTP income, including qualified REIT dividends and qualified PTP income earned through pass-through entities. This component of the deduction is not limited by W – 2 wages or the unadjusted basis in qualified property.

- 7. As s a general rule, the Section 199A deduction is the lesser of:
  - The Combined Qualified Business Income Amount of the taxpayer, or
  - 20% of the excess, if any, of the taxable income of the taxpayer for the tax year over the net capital gains (Taxable Income - Net Capital Gains). (See Section 199A(c))

A. Overview

- 8. Combined Qualified Business Income Amount refers to an amount equal to:

- The deductible amount for **<u>each</u>** qualified trade or business, as defined below.

- + 20% of the aggregate amount of qualified REIT dividends and qualified PTP income.

- 9. The deductible amount for **<u>each</u>** qualified trade or business is defined as the lesser between:

A. Overview

- 20% of the taxpayers Qualified Business Income (QBI) or

- The greater of:

- 50% of W – 2 Wages (This represents W-2 Wages from either a sole proprietorship or allocable share from a pass-through entity, also known as the Wage Limit) or

- 25% of the W – 2 Wages +2.5% of the unadjusted basis immediately after acquisition of Qualified Property. (This is also known as the Wage/Basis Limit)

A. Overview

- \+ 20% of the aggregate amount of Qualified REIT Dividends and Qualified PTP Income
- 10. The Wages Limit and Wage/Basis Limit must be provided from each pass-through entity (S Corporation or Partnership) that has or that pays wages and has unadjusted basis of after-acquired depreciable property that is qualified in nature and as defined in this provision.
- 11. Qualified Property refers to tangible, depreciable property that is:
  - held by available for use in the qualified trade or business at the close of the taxable year,
  - used at any point during the tax year in the production of qualified business income, and
  - the depreciable period for which has not ended before the close of the tax year.
- 12. The Wages Limit and Wage/Basis Limit does not apply in all cases. The Wage Limit and Wage/Basis Limit does not apply if the taxpayer's taxable income before the qualified business income deduction is below a threshold amount.
- **13. Threshold Amounts**

A. Overview

- a. The threshold amounts for 2024 are as follows: (Rev. Proc. 2023-34):

A. Overview

Filing Status	Taxable Income Before QBI
Married Filing Joint	$ 383,900
Single and HOH	$191,950
Married Filing Separately	$191,950

A. Overview

- b. The threshold amounts for 2025 are as follows: (Rev. Proc. 2024-40):

A. Overview

Filing Status	Taxable Income Before QBI
Married Filing Joint	$394,600
Single and HOH	$197,300
Married Filing Separately	$197,300

A. Overview

- 14. The application of the Wage Limit and Wage/Basis Limit is phased-in for taxpayers whose taxable income exceeds these threshold amounts. When the limitation applies, the limit is phased in when the taxpayer's taxable income exceeds the threshold amounts. Specifically, as follows:
  - a phase in over the next $100,000 of taxable income for married filing jointly
  - a phase in over the next $50,000 of taxable income for all other filers.
- 15. Prior to determining the deduction, the taxpayer must determine the taxpayer's taxable income before determining the Qualified Business Income deduction.
- 16. Hence, the deduction is not allowed in computing adjusted gross income but is a deduction reducing taxable income.

A. Overview

- 17. Hence, the first thing the tax preparer must do is determine taxable income before determining Qualified Business Income.
- **18. Taxable Income Is Below the Threshold Amount**
- If taxable income is below the threshold amount, the QBI deduction is 20% of each trade or businesses' QBI, subject only to the taxable income limitation.
- **19. Taxable Income is Above the Threshold Minimum, But Not Above the Maximum**
- If taxable income falls between the threshold and the top of the phase-in range, a limitation on the QBI deduction is phased in. The limitation phase-in reduces the QBI deduction by a percentage calculated with the numerator being the amount of taxable income in excess of threshold for the filing status and the denominator being $50,000 ($100,000 for MFJ).
- **20.Taxable Income is Above the Threshold Maximum**
- If a taxpayer's taxable income is above the threshold maximum, no QBI deduction is allowed unless the taxpayer has W-2 wages or UBIA allocable to the trade or business.

B. Who Can Claim the Deduction?

- 1. To reiterate, the Section 199A deduction is taken by individuals and by certain trusts and estates. The available sources for the deduction include the following:
  - Individual owners of sole proprietorships,
  - Rental properties, (Safe Harbor?)
  - S corporations,
  - Partnerships, and
  - Certain trusts and estates

B. Who Can Claim the Deduction?

- 2. In other words, the qualified business income deduction is available to businesses that are a qualified trade or business which could include the above list or a combination thereof.

- 3. Specified Agricultural or Horticultural Cooperatives may claim a special entity level deduction that is substantially similar to the domestic production activity deduction under former Section 199. The amount determined with respect to such trade or business is reduced by the lesser of 9% of QBI with respect to the trade or business as is allocable to qualified payments received from the cooperative or 50% of the W-2 wages respect to the trade or business.

B. Who Can Claim the Deduction?

- 4. The deduction is not available for taxpayers that are:
  - Employees with no equity or capital ownership in a business,
  - Businesses that are characterized as specified service trade or business.

- 5. Except as otherwise provided, the deduction does not apply specified service trade or businesses. These types of businesses are generally defined under Section 1202(e)(3) (A). Section 199A (d) (2) defines a specified service trade or business by reference to Section 1202 (e) (3) (A), which includes among the businesses ineligible for the benefits of that section:

- any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

B. Who Can Claim the Deduction?

- 6. However, businesses involving engineering and architecture are not considered specified service trade or businesses. Therefore they are eligible for the 20% deduction.
- 7. The deduction has no effect on adjusted basis of a shareholder or partner's interest nor does it have an impact on the S corporations AAA account.
- 8. The deduction does not reduce net earnings from self-employment tax nor does it impact net investment income tax.
- 9. For purposes of determining alternative minimum taxable income the deduction allowed under this provision equals the deduction allowed in determining taxable income for the year without regard to any alternative minimum tax adjustment.
- **10. Specified Services Limitation**

B. Who Can Claim the Deduction?

- a. The QBI Deduction Is Not Allowed for “Specified Service” Business Income
- b. A “specified service trade or business” includes personal-service-type trades or businesses involved in the following performance of services: health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services (including investing and investment management, trading, or dealing in securities, partnership interests, or commodities), and any trade or business where the principal asset is the reputation or skill of one or more of its owners or employees.
- c. The exclusion of SSTBs from QBI is subject to a phase-in over the same dollar range as the taxable income limitation phase-in.

II. Qualified Business Income – Section 1.199A – 3

A. Definition

- 1. Qualified Business Income (QBI) means , for any tax year, the net amount of qualified items of income, gain, deduction and loss with respect to aid any trade or business or aggregated trade or business.

- 2. Qualified Items of income, deduction, gain and loss. This refers to items of gross income, gain, deduction and loss to the extent such items are:

- a. Effectively connected with the conduct of a trade or business within the United States, and

- b. Are included or allowed in determining taxable income for the taxable year.

- The following items are not taken into account as qualified items of income, gain, deduction or loss and are thus not included in determining qualified business income:

A. Definition

- a. Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items under any other provision of the Code. This provision does not apply to the extent an item is treated as anything other than short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

- b. Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in Section 954(c)(1)(G). Any amount described in Section 1385(a)(1) is not treated as described in this clause.

- c. Any interest income other than interest income which is properly allocable to a trade or business. For purposes of Section 199A and this section, interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.

A. Definition

- d. Any item of gain or loss described in Section 954(c)(1)(C) (transactions in commodities) or Section 954(c)(1)(D) (excess foreign currency gains) applied in each case by substituting "trade or business (within the meaning of Section 199A) " for "controlled foreign corporation."

- e. Any item of income, gain, deduction, or loss described in Section 954(c)(1)(F) (income from notional principal contracts) determined without regard to Section 954(c)(1)(F)(ii) and other than items attributable to notional principal contracts entered into in transactions qualifying under Section 1221(a)(7).

- f. Any amount received from an annuity which is not received in connection with the trade or business.

A. Definition

- g. Any qualified REIT dividends as defined in paragraph (c)(2) of this section or qualified PTP income as defined in paragraph (c)(3) of this section.

- h. Reasonable compensation received by a shareholder from an S corporation. However, the S corporation's deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

A. Definition

- i. Any guaranteed payment described in Section 707(c) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

- j. Any payment described in Section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes

A. Definition

- 3. It should be noted that all wages paid or incurred must be taken into account in computing QBI (if the requirements of this section and Section 199A are satisfied) regardless of the application of the W-2 wage limitation described in §1.199A-1(d)(2)(iv).

- 4. If an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances.

- a. The proposed regulations had referenced a direct tracing method or an allocation based on gross income. These were specifically removed and the emphasis in the commentary was a reasonable method can be adopted but it must be applied on a consistent basis.

A. Definition

- 5. The individual or RPE may use a different reasonable method with respect to different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business.

- 6. The overall combination of methods must also be reasonable based on all facts and circumstances. The books and records maintained for a trade or business must be consistent with any such allocations method.

- **7. Section 751 Gain**. With respect to a partnership, if Section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under Section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI. This refers to hot assets, appreciating inventory and unrealized accounts receivable.

A. Definition

- **8. Guaranteed Payments for the use of Capital**. Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI except to the extent properly allocable to a trade or business of the recipient. The partnership's deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

- a. The Service is taking the position that guaranteed payments for the use of capital are not attributable to a trade or business of the partnership because they are determined without regard to partnerships income. As such, they should generally not be considered part of QBI. Rather, such payments are considered more along the lines of interest income should be treated as interest income which is not includable in the computation.

A. Definition

- **9. Section 481 Adjustments**. Section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section is otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017. Thus, only Section 481 adjustments that arise after December 31, 2017 are taken into account in determining QBI.

- a. Income from installment sales and deferred cancellation of debt income arising in tax years ending before January 1, 2018 should not be taken into account for purposes of computing QBI. Several commentators have recommended that items deferred under Revenue Procedure 2004 – 34, 2004 – C. B. 911 should be included in QBI. The IRS continues to study the issue and may issue a proposed regulation.

A. Definition

- **10. Previously Disallowed Losses**. Generally, previously disallowed losses or deductions (including under Sections 465, 469, 704(d), and 1366(d)) allowed in the taxable year are taken into account for purposes of computing QBI. These losses shall be used, for purposes of Section 199A and these regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under Sections 465, 469, 704(d), and 1366(d)), are not taken into account in a later taxable year for purposes of computing QBI.

- a. The Service in its commentary indicated that losses disallowed, suspended or limited under Sections 465, 469, 704(d), and 1366(d) ordering rule for the use of losses should be in the order from the oldest to the most recent on a FIFO basis.

A. Definition

- b. The IRS is going to issue proposed regulations that treat previously suspended losses as losses from a separate trade or business for purposes of Section 199A.

- **11. Net Operating Losses**. Generally, a net operating loss deduction under Section 172 is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, an excess business loss under Section 461(l) is treated as a net operating loss carryover to the following taxable year and is taken into account for purposes of computing QBI in the subsequent taxable year in which it is deducted.

- **12. Other Deductions**. Generally, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of Section 199A and this section are otherwise satisfied. For purposes of Section 199A only, deductions such as the following are considered other deductions:

A. Definition

– deductible portion of the tax on self-employment income under Section 164(f),

– the self-employed health insurance deduction under Section 162(l), and

– the deduction for contributions to qualified retirement plans under Section 404 are considered attributable to a trade or business to the extent that the individual’s gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.

A. Definition

- a. The commentary on the final regulation addressed this category of other deductions reiterated that All deductions attributable to a trade or business should be taken into account for purposes of computing QBI except to the extent provided by section 199A and these regulations. Accordingly, §1.199A-3(b)(1)(vi) provides that, in general, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of section 199A and §1.199A-3 are otherwise satisfied. Thus, for purposes of section 199A, deductions such as the deductible portion of the tax on self-employment income under section 164(f), the self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404 are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis.

- b. The Treasury and IRS declined to address whether deductions for unreimbursed partner expenses, interest to acquire a partnership and S Corp interests and state and local taxes are attributable to a trade or business. It would appear that those are based on facts and circumstances.

A. Definition

- **13. Section 1231**. Several commentators noted that whether a taxpayer has long-term capital gains or losses under Section 1231 is determined at the taxpayer level and not at the level of the trade or business for which QBI is determined.

- a. The IRS determined that for purposes of Section 199A that taxpayers net their Section 1231 gains and losses from multiple trade or businesses to determine whether they have an excess gain.

- b. Likewise, the recapture rules under Section 1231(c) continue to apply. Under this rule, a taxpayer that has a Section 1231 capital gain in the current year must look back any Section 1231 ordinary loss taken in the previous five years and convert a portion of the Section 1231 capital gain to ordinary gain based upon the previous losses taken.. That continues in determining QBI.

A. Definition

- c. The final regulations remove reference to Section 1231 and state specifically that to the extent an item is not treated as an item of capital gain or capital loss under any other provision of the Code, it is taken into account as a qualified item of income, gain, deduction, or loss unless otherwise excluded by Section 199A or these regulations.

- 14. As discussed on the IRS website, FAQ 23 states that a taxpayer with a Schedule C Business does not necessarily have QBI equal to the net profit on the Schedule C. The Service is taking the position that with respect to the Schedule C business that the QBI be adjusted by any other items of gain or deduction related to the business, including but not limited to the following:
  - gains from Form 4797,
  - the deductible part of self-employment tax,
  - self-employed health insurance,
  - self-employed SEP, SIMPLE, and qualified plan deductions.

A. Definition

- Amounts received as W-2 income, reasonable compensation from an S corporation, guaranteed payments from a partnership, and payments received by a partner for services under section 707(a) are not QBI and are not eligible for the deduction.

- 15. Under IRS, FAQ 33, health insurance premiums paid by the S corporation for a greater than 2% shareholder reduces qualified business income at the entity level by reducing ordinary income used to compute the allocable qualified business income share. If a taxpayer takes the self-employed health insurance deduction on their tax return. They are to include the deduction in calculating qualified business income from the S corporation. This may result in qualified business income being lower at both the entity and the shareholder level.

B. Qualified REIT Dividends

- 1. The term qualified REIT dividend means any dividend from a REIT received during the taxable year which:
  - Is not a capital gain dividend, as defined in Section 857(b)(3), and
  - Is not qualified dividend income, as defined in Section 1(h)(11).

- 2. The term qualified REIT dividend does not include any REIT dividend received with respect to any share of REIT stock that:
  - Is held by the shareholder for 45 days or less (taking into account the principles of Section 246(c)(3) and (4)) during the 91-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend, or
  - To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

C. Qualified PTP Income

- 1. The term qualified PTP income means the sum of:
- The net amount of such taxpayer’s allocable share of income, gain, deduction, and loss from a PTP as defined in Section 7704(b) that is not taxed as a corporation under Section 7704(a),
- +
- Any gain or loss attributable to assets of the PTP giving rise to ordinary income under Section 751(a) or (b) that is considered attributable to the trades or businesses conducted by the partnership.

C. Qualified PTP Income

- 2. The rules applicable to the determination of QBI also apply to the determination of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP.

- 3. An individual's allocable share of income from a PTP, and any Section 751 gain or loss is qualified PTP income only to the extent the items meet the qualifications of Section 199A and this section, including the requirement that the item is included or allowed in determining taxable income for the taxable year, and the requirement that the item be effectively connected with the conduct of a trade or business within the United States.

C. Qualified PTP Income

- 4. For example, if an individual owns an interest in a PTP, and for the taxable year is allocated a distributive share of net loss which is disallowed under the passive activity rules of Section 469, such loss is not taken into account for purposes of Section 199A.

- 5. The specified service trade or business limitations also apply to income earned from a PTP.

- 6. Each PTP is required to determine its qualified PTP income for each trade or business and report that information to its owners as described in §1.199A-6(b)(3)

- 7. If a taxpayer receives a K-1 allocating a PTP loss, but loss is currently not allowable. Do to the passive activity rules. It is not used in computing the REIT/PTP component as it is not included in taxable income. Hence, it is not used in computing the QBI deduction. In a later year, when the losses allowable, lost, generated in 2018 would be used in computing the REIT/PTP component. (See IRS FAQ 31)

D. Mineral Interest

- 1. Both the proposed regulations and final regulations did not specifically include or exclude mineral interest or working interest from the Section 199A deduction. As such, taxpayers must look to other areas of the Internal Revenue Code for guidance.

D. Mineral Interest

- 2. In order to classify income from a mineral interest, the taxpayer must know how the income is derived. For federal tax purposes, a mineral interest is known as a bundle of legal rights that may be severed from the surface. Obviously, it is possible for the owner minerals not to own the surface layer. When mineral interests are separated in this way, there are generally two types of rights:
  - Rights to receive lease benefits which include the right to receive bonus payments, delay rentals and royalties. When a mineral interest owner grants a lease, the right to develop is relinquished and vest with the lessee operator. That distinction is critical in the classification of royalties versus a working or operate interest
  - Rights to develop the mineral estate often include the right to develop and produce the minerals. This is generally associated with a working or operating interest.

D. Mineral Interest

- 3. In examining the definition of qualified business income. It appears that portfolio income are generally excluded from qualified business income. However, working interest income are generally viewed as a trade or business activity. The support for this stems from Section 1411 which imposes the 3.8% tax on net investment income of the taxpayer above certain thresholds. The definition of net investment income includes royalties other than those items derived from a non-passive trade or business. S 469, which is the passive income provisions states that portfolio income can include royalties from a mineral interest unless derived in the ordinary course of a trade or business. This would appear to include all and gas royalties, overriding royalties, but this would not include those that are a dealer in royalties. (See Reg. Sec. 1.469 – 2T(c (3))

D. Mineral Interest

- 4. In addition Royalties are not burdened with production cost as of the sale or exchange world interest is generally treated as the sale or exchange of a capital asset. (Revenue Ruling 73 – 428)

- 5. A working interest generally is treated as a trade or business activity because it is burdened with the cost of production, development and operation. The income and losses generally treated as subject to self-employment tax. (See . Cokes v. Commissioner, 91 T.C. 222 (1988); and, Methvin v. Commissioner, T.C. Memo. 2015-81, aff'd, 2016 WL 3457623 (10th Cir. 2016) where it small individual working interest owner who is not designated the operator of an oil and gas property was held liable for self-employment tax on trade or business income.)

D. Mineral Interest

- a. Likewise, there is nothing in the proposed nor final regulations of Section 199 a that states a working interest in all and gas is excluded from the definition of qualified trade or business. Assuming the working interest is assessing with a domestic trade or business, based upon the above, it appears that the working interest would be qualified business income associate with a qualified trade or business, and thus the deduction would be allowed.

- 6. In essence, mineral interest held for investment purposes only, are not likely to qualify for the 20% deduction, but non-investment like a working interest appears to be eligible. If the working interest is considered qualified business income eligible for the deduction, it should be identified as such is either on a K – 1 or Form 1099 – M ISC other than royalty.

III. Determination of W – 2 Wages – Regulation 1.199 A – 2

A. General Rule

- 1. The determination of W-2 wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business(or aggregated trade or business). This is the case irrespective of taxable income of the individual taxpayer. It is particularly the case with RPE that is a qualified trade or business.
- 2. In the case of W-2 wages paid by an RPE, the RPE must determine and report W-2 wages for each trade or business (or aggregated trade or business) conducted by the RPE.
- 3. W-2 wages are presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).
- 4. Section 199A(b)(2)(B) provides limitations on the Section 199A deduction based on the W-2 wages paid with respect to each trade or business (or aggregated trade or business).

A. General Rule

- 5. Section 199A(b)(4)(B) provides that W-2 wages do not include any amount which is not properly allocable to QBI for purposes of Section 199A(c)(1). This section provides a three step process for determining the W-2 wages paid with respect to a trade or business that are properly allocable to QBI.
- a. Each individual or RPE must determine its total W-2 wages paid for the taxable year.
- b. Each individual or RPE must allocate its W-2 wages between or among one or more trades or businesses.
- c. Each individual or RPE must determine the amount of such wages with respect to each trade or business , which are allocable to the QBI of the trade or business (or aggregated trade or business).

B. Definition

- 1. Section 199A(b)(4)(A) provides that the term W-2 wages means with respect to any person for any taxable year of such person, the amounts paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

- 2. Thus, the term W-2 wages includes the following:
  - the total amount of wages as defined in Section 3401(a)
  - the total amount of elective deferrals (within the meaning of Section 402(g)(3)),
  - the compensation deferred under Section 457,and
  - the amount of designated Roth contributions (as defined in Section 402A).

B. Definition

- 3. For this purpose, the Forms W-2, “Wage and Tax Statement,” or any subsequent form or document used in determining the amount of W-2 wages, are those issued for the calendar year ending during the individual’s or RPE’s taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE.

- 4. Employees of the individual or RPE are limited to employees of the individual or RPE, this includes officers of an S corporation and employees of an individual or RPE under common law.

C. Wages Paid by a Person Other Than a Common Law Employer

- 1. In determining W-2 wages, an individual or RPE may take into account any W-2 wages paid by another person and reported by the other person on Forms W-2 with the other person as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE.

- 2. In such cases, the person paying the W-2 wages and reporting the W-2 wage son Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that person.

- 3. Persons that pay and report W-2 wages on behalf of or with respect to others can include, but are not limited to, certified professional employer organizations under Section 7705, statutory employers under Section 3401(d)(1), and agents under Section 3504. The language seems to indicate that non-certified professional employee organizations and management companies that pay wages on behalf of employers would allow the employer to use the wages in determining the extent or application of the deduction for taxpayers that are subject to any limitation.

D. Requirements that Wages must be Reported on Returns Filed with the Social Security Administration (SSA)

- 1. The W-2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return.
- 2. Each Form W-2 and the transmittal Form W-3, "Transmittal of Wage and Tax Statements," together constitute an information return to be filed with SSA. Similarly, each Form W-2c, "Corrected Wage and Tax Statement," and the transmittal Form W-3 or W-3c, "Transmittal of Corrected Wage and Tax Statements," together constitute an information return to be filed with SSA.
- 3. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W-2 together with its accompanying Form W-3 will be considered a separate information return and each Form W-2c together with its accompanying Form W-3 or Form W-3c will be considered a separate information return.

D. Requirements that Wages must be Reported on Returns Filed with the Social Security Administration (SSA)

- 4. Section 6071(c) provides that Forms W-2 and W-3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in §31.6071(a) -T(a)(3)(1) of this chapter for monthly returns filed under §31.6011(a)-5(a) of this chapter).

- 5. Corrected Forms W-2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

- 6. Corrected return filed to correct a return that was filed within 60 days of the due date. If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) then the wage information on Return B must be included in determining W-2 wages

D. Requirements that Wages must be Reported on Returns Filed with the Social Security Administration (SSA)

- 7. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), and if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D will be disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages).

D. Requirements that Wages must be Reported on Returns Filed with the Social Security Administration (SSA)

- 8. If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) then the wage information on Return B must be included in determining W-2 wages.

D. Requirements that Wages must be Reported on Returns Filed with the Social Security Administration (SSA)

- 9. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), and if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D will be disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages).

- 10. If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

D. Requirements that Wages must be Reported on Returns Filed with the Social Security Administration (SSA)

- 11. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return).

- 12. Thus, if a Form W-2c is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2 (or to correct a Form W-2c relating to Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2), then this Form W-2c will not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W-2c (or corrected Form W-2), regardless of when the Form W-2c is filed.

E. Methods for Calculating W-2 Wages

- 1. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W-2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, "Wage and Tax Statement."

- 2. The term acquisition or disposition includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets.

E. Methods for Calculating W-2 Wages

- 3. In the case of an individual or RPE with a short taxable year, the W-2 wages of the individual or RPE for the short taxable year include only those wages paid during the short taxable year to employees of the individuals or RPE , only those elective deferrals made during the short taxable year by employees of the individual or RPE and only compensation actually deferred under Section 457 during the short taxable year with respect to employees of the individual or RPE.

- 4. If an individual or RPE has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by such individual or RPE during the short taxable year are treated as W-2 wages for such short taxable year.

E. Methods for Calculating W-2 Wages

- 5. After calculating total W-2 wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W-2 wages must be allocated to the trade or business that generated those wages. In the case of W -2 wages that are allocable to more than one trade or business, the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under §1.199A-3(b)(5).

E. Methods for Calculating W-2 Wages

- 6. Once W-2 wages for each trade or business have been determined, each individual or RPE must identify the amount of W-2 wages properly allocable to QBI for each trade or business (or aggregated trade or business).

- 7. In the case of an RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code. The RPE must also identify and report the associated W-2 wages to its partners or shareholders.

- 8. In essence, amounts paid as W-2 wages to S corporation shareholder cannot be included in the determination of qualified business income. But, these amounts are included as W-2 wages for purpose of the application of the wage limitation.

F. Revenue Procedure 2019 – 11

- 1. This Revenue Procedure provides the methods for calculating the W-2 wages for purposes of the qualified business income deduction computation.

- 2. There are three methods applicable for calculating the W-2 wages. The three methods are as follows:

- **a. Unmodified Box Method**. The W-2 wages calculated are determined by taking the lesser of:
  - The total entries in Box 1 all W-2s filed with SSA by the taxpayer with respect to employees of the taxpayer or
  - The total entries in Box 5 of all W-2s filed with SSA by the taxpayer with respect to employees of the taxpayer.

- **b. Modified Box 1 Method**. The taxpayer makes modifications to the total entries in Box 1 of W-2s filed with respect to employees of the taxpayer. Under this approach, W-2 wages are calculated as follows:

F. Revenue Procedure 2019 – 11

- (The total entries in Box 1 all W-2s filed with SSA by the taxpayer with respect to employees of the taxpayer) - (Amounts included in Box 1 of Forms W-2 that are not wages for federal income tax withholding purposes, including amounts that are treated as wages for purposes of federal income tax withholdings + the total amounts reported in Box 12 of Forms W-2 that are coded as code D, E, F, G and S).

- **c. Tracking Wages Method**. The taxpayer actually tracks total wages subject to federal income tax withholdings and makes appropriate modifications. The W-2 wages under this method are calculated as follows:

- (Total amounts of wages subject to federal withholdings that are paid to employees of the taxpayer for employment and then a reported on Form W-2s filed with the SSA for the calendar year) + (the total amounts reported in box 12 a Form W-2s that are properly coded as D, E, F, G, and S)

F. Revenue Procedure 2019 – 11

- 3. The elective deferrals under box 12 refer to the following:

F. Revenue Procedure 2019 – 11

- Code D is for elective deferrals to a Section 401(k) cash or deferred arrangement plan (including a SIMPLE 401(k) arrangement);
- Code E is for elective deferrals under a Section 403(b) salary reduction agreement;
- Code F is for elective deferrals under a Section 408(k)(6) salary reduction Simplified Employee Pension (SEP);
- Code G is for elective deferrals and employer contributions (including nonelective deferrals) to any governmental or nongovernmental Section 457(b) deferred compensation plan;
- Code S is for employee salary reduction contributions under a Section 408(p)

- 4. For short tax years there is no annualization.

IV. UBIA Qualified Property

A. General Rules

- 1. The determination of the UBIA of qualified property must be made for each trade or business(or aggregated trade or business) by the individual or RPE that directly conducts the trade or business (or aggregated trade or business).

- 2. The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).

- 3. In case of qualified property held by either a partnership or an S Corporation each partner or shareholder share of the UBIA of qualified property is the allocable share of the unadjusted basis in the case of an S corporation or in the case of a partnership how depreciation is allocated pursuant to the partnership agreement at the end of the tax year.

B. Definition

- 1. The term qualified property means, with respect to any trade or business (or aggregated trade or business) of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under Section 167(a):
- a. Which is held by, and available for use in, the trade or business (or aggregated trade or business) at the close of the taxable year,
- b. Which is used at any point during the taxable year in the trade or business's (or aggregated trade or business's) production of QBI, and
- c. The depreciable period for which has not ended before the close of the individual's or RPE's taxable year.

B. Definition

- 2. In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service for purposes of this section.

- 3. Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days of acquisition without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the Section 199A deduction.

B. Definition

- 4. The term depreciable period means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE
- and ending on the later of :
  - The date that is 10 years after such date, or
  - The last day of the last full year in the applicable recovery period that would apply to the property under Section 168(c), regardless of any application of Section 168(g).
- 5. The additional first-year depreciation deduction allowable under Section 168 does not affect the applicable recovery period for the qualified property.

B. Definition

- 6. The term unadjusted basis immediately after acquisition (UBIA) means the basis on the placed in service date of the property as determined under Section 1012 or other applicable sections of Chapter 1 of the Code, including :
  - the provisions of subchapters O (relating to gain or loss on dispositions of property),
  - the provisions of subchapters C (relating to corporate distributions and adjustments),
  - the provisions of subchapters K (relating to partners and partnerships), and
  - the provisions of subchapters P (relating to capital gains and losses).

B. Definition

- 7. UBIA is determined without regard to any adjustments for tax credits claimed by the individual or RPE or to any adjustments for any portion of the basis which the individual or RPE has elected to treat as an expense (for example, under sections 179, 179B, or 179C).

- 8. However, UBIA does reflect the reduction in basis for the percentage of the individual’s or RPE’s use of property for the taxable year other than in the trade or business.

Example

- On January 5, 2012, Bubba purchases Real Property X for $1 million and places it in service in his trade or business. Bubba' s trade or business is not an SSTB. Bubba's basis in Real Property X is $1 million. Assume that Real Property X is qualified property within the meaning of Section 199A(b)(6). As of December 31, 2018, Bubba's basis in Real Property X, as adjusted under Section 1016(a)(2) for depreciation deductions under Section 168(a), is $821,550.

- Bubba's UBIA of Real Property X is its $1 million cost basis under Section 1012, regardless of any later depreciation deductions under Section 168(a) and resulting basis adjustments under Section 1016(a)(2).

V. Aggregation – Regulation 1.199A – 4

A. General

- 1. An individual or RPE may be engaged in one or more trade or businesses. As a general rule, each trade or business is separate for purposes of applying the caps Section 199A limitations.
- 2. Regulation 1.199A – 4 provides an exception to the general rule to allow individuals and RPE's to aggregate trade or business is treating them as a single trade or business for purposes of the limitation associated with the Section 199A deduction.
- 3. Aggregation is purely voluntary it is not required.
- 4. Trade or businesses may be aggregated only if the individual taxpayer or RPE can demonstrate the following:

A. General

- The same person or groups of persons, directly or by attribution under Section 267(b) or 707(b) owns 50% or more of each trade or business to be aggregated. The 50% rule of such trade or businesses owned by S corporation refers to 50% or more of the issued and outstanding shares of the corporation. In the case of a partnership, the rule applies to 50% or more of the capital and profits of the partnership. It should be noted that the regulations do not require that every person involved in the ownership determination on an interest in every trade or business. The rule is satisfied so long as one person or group or persons holds a 50% or more ownership interest in each trade or business.;

- The ownership exists for a majority of the tax year, including the last day of the tax year, in which the items attributable to each trade or business to be aggregated are included in income;

- All the items attributable to each trade or business to be aggregated are reported on returns with the same tax year, not taking into account short tax years;

A. General

- None of the trade or businesses to be aggregated can be a specified service trade or business (SSTB); and
- The trades or businesses to be aggregated satisfy at least two of the following factors:
- The trades or businesses provide products, property or services that are the same for customarily offered together.
- The trades or businesses share facilities or share certificates centralize business elements, such as personnel, accounting, legal, manufacturing, producing common human resources or information technology resources.
- The trades or businesses are operating coordination with, or reliance upon, one or more the businesses in the aggregated group.

B. Operating Rules

- 1. Individual Taxpayers
- a. An individual taxpayer may aggregate trades or businesses operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE.
- b. If an individual aggregates multiple trades QBI, W-2 wages, and UBIA of qualified property must be combined for the aggregated trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations.

B. Operating Rules

- c. An individual may not subtract from the trades or businesses aggregated by an RPE but may aggregate additional trades or businesses with the RPE's aggregation if the rules of this section are otherwise satisfied.

- 2. RPE's.

B. Operating Rules

- a. An RPE may aggregate trades or businesses operated directly or through a lower -tier RPE to the extent an aggregation is not inconsistent with the aggregation of a lower-tier RPE. This is a change as it was not in the proposed regulations. As such, the final rags permit an RPE to aggregate trade or businesses it operates directly or through lower tiered RPE's. The resulting aggregation must be reported not only by the RPE but by the owners of the RPE. An individual taxpayer upper tier RPE cannot separate the aggregation trade or business of the lower tier RPE but must maintain the lower tier RPE's aggregation.

- b. If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner. If an RPE aggregates multiple trades or businesses, the RPE must compute and report QBI, W-2 wages, and UBIA of qualified property for the aggregated trade or business under the rules described in §1.199A-6(b).

- c. An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE's aggregation if the rules of this section are otherwise satisfied.

VI. Losses

A. General Rule

- 1. If the total QBI amount is less than zero, the portion of the taxpayer's Section 199A deduction related to QBI is zero or the tax year.
- 2. The negative total amount is treated as negative QBI from a separate trade or business in the succeeding tax years.
- 3. The carryover rule does not affect the deductibility of the loss for purposes of other provisions of the internal revenue Code.
- 4. Likewise, if the combined amount of REIT dividends and qualify PTP income is less than zero, the portion of the taxpayer's Section 199 A deduction related to qualified REIT dividends and qualified PTP income is zero for the year.
- 5. The negative combined amount must be carried forward and used to offset combined amounts of REIT dividends and qualified PTP income in the succeeding tax years for purposes of this deduction.

B. Netting

- 1. If a taxpayers qualified business income from at least one trade or business, including an aggregated trade or business) is less than zero, the taxpayer must offset the QBI attributable to each trade or business (or aggregated trade or business) that produced net positive QBI with the QBI from each trade or business (or aggregated trade or business) that produced net negative QBI in proportion to the relative amounts of net QBI in the trade or business (or aggregate trade or businesses) with positive QBI.

- 2. If the taxpayers QBI from all trade or businesses combined or aggregated is less than zero, the QBI component is zero for the tax year. The negative amount is treated as negative QBI from a separate trade or business in the succeeding tax year for purposes of the deduction. The carryover does not impact the deductibility of the loss for purposes of other provisions of the Internal Revenue Code.

- 3. The W-2 wages and UBIA of qualified property from trade or businesses that produced the net negative QBI are not taken into account and are not carried over to the subsequent tax year.

VII. Trusts and Estates – Regulations 1.199A – 6

A. General

- 1. A trust or estate computes its Section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate.

- 2. An individual beneficiary of a trust or estate takes into account any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's Section 199A deduction, in the same manner as though the items had been allocated from an RPE.

- 3. For purposes of this section and §§1.199A-1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.

B. Grantor Trusts

- 1. To the extent that the grantor or another person is treated as owning all or part of a trust under Sections 671 through 679, such person computes its Section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or other person.

C. Non-Grantor Trusts and Estates

- 1. A trust or estate must calculate its QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in Section 199A(c)(3) in accordance with the classification of those deductions under §1.652(b)-3(a), and deductions not directly attributable within the meaning of §1.652(b) -3(b) (other deductions) are allocated in a manner consistent with the rules in §1.652(b)-3(b).

- 2. Any depletion and depreciation deductions described in Section 642(e) and any amortization deductions described in Section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

C. Non-Grantor Trusts and Estates

- 3. The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by Section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate.

- 4. For this purpose, the trust's or estate's DNI is determined with regard to the separate share rule of Section 663(c), but without regard to Section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.

C. Non-Grantor Trusts and Estates

- 5. The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be $157,500 increased by the cost-of-living adjustment as outlined in §1.199A-1(b)(12).

- 6. For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under Sections 651 or 661.

Example

- Assume a trust is an irrevocable testamentary complex trust and a 25% partner in ABC, a family partnership that operates a restaurant which generates qualified business income and W-2 wages in 2018. ABC allocates gross income from the restaurant of $55,000 and expenses directly allocable of $50,000 to the trust consisting of $25,000 of W-2 wages, depreciation of $5000 in miscellaneous expenses of $20,000. The trust share of the unadjusted basis of qualified property in the partnership is $125,000. The partnership also distributed $5, 000 of cash to the trust in 2018. The trust also operates a bakery conducted through an LLC that is wholly owned by the trust. The LLC is treated as a disregarded entity. The bakery produced $100,000 of gross income and $150,000 of expenses directly allocable to the operations of the bakery. The $150,000 of expenses consisted of $50,000 of W-2 wages, $75,000 of rent expense and $25,000 of miscellaneous expenses. The bakery had no unadjusted basis of qualified property. The trust has chosen to aggregate the restaurant conducted through the partnership with the bakery conducted directly through the trust. In addition, the trust owns various investments that produce portfolio income.

Example

- For 2018 this consisted of dividends of $25,000, interest income of $15,000 in tax exempt interest income of $15,000. Also, the trust had trustee commissions of $3000 in state and local taxes it paid up $5000. The net loss from the partnership and the bakery as a result was ($45,000). In determining the trust DNI for the taxable year, the distributive share of the expenses of the partnership are directly allocable to the distributive share of income from the partnership. The trust as a result had gross business income of $155,000 ($55,000 from the partnership and $100,000 from the bakery). The trust had direct business expenses totaling $200,000 ($50,000 from the partnership and $150,000 from the bakery). In addition, $1000 of the trustees commissions and $1000 of state and local taxes are directly attributable to the trust business income. The trust has excessive business deductions of $47,000. This consists of the net business loss from both the partnership and the bakery of $45,000 plus the thousand dollars of trustee commissions and the thousand dollars of state and local taxes directly attributable to the business income. The trust is required to allocate the $47,000 of excess business deductions as follows:

Example

- $15,000 to interest income
- $25,000 to dividend income
- $7000 to tax-exempt income.

- As a result interest income reporting and dividend income reporting is zero and the tax exempt income is reduced from $15,000-$8000. The trust must allocate the balance of the trust commissions ($2000) and state and local taxes ($4000) to the trust remaining tax-exempt income resulting in the tax-exempt income being reduced further to $2000.

Example

- In 20 18, the trust as DNI of $2000. Under the trust agreement, the trustee distributes 50% of the DNI or $1000 to Moe, a discretionary beneficiary of the trust. The trustee is required to distribute under the agreement 25% of the DNI ($500) to Larry, a current income beneficiary. The trust retains the remaining 25% of DNI. As a result, Moe excludes $1000 of tax exempt interest income and be excludes $500 a tax-exempt income. Since the DNI consist at this point of nothing but tax-exempt income, the trust deducts nothing with respect to the distributions to the beneficiaries.

Example

- The trust had combined W-2 wages in 2018 of $75,000 and $125,000 of unadjusted basis in qualified property. However, the trust had negative QBI a $47,000. Since the $1000 trust distribution to Moe equals one half of the trust DNI, Moe has W-2 wages from the trust of $37,500. He also has wages of $2500 from a trade or business outside of the trust which he aggregated with the trust trade or business for a total of $40,000 of W-2 wages from the aggregate trade or business. Moe also has $100,000 of qualified business income from a non-trust trade or business in which he owns an interest. Since the thousand dollar trust distribution to him equals one half of the trust DNI his negative QBI from the trust is $23,500.. The negative amount can be offset against the positive amount leaving a combined QB I of $76,500. If his taxable income exceeds the threshold for 2018 by $200,000 then his tentative deduction is 20% of $76,500 or $15,300 limited under the wage limitation to $20,000 (50% times $40,000) hence his deduction is $15,300.

Example

- Asked to Larry, if it is assumed that his taxable income is below the threshold amount he is not subject to any wage limitation. The $500 trust distribution to him equals 25% of the trust DNI. Larry has a total of negative $11,750 of QB I and has no non-trust trade or business. As such his deduction is zero because it is a loss and would thus be carried over to the following year.

- The trust has taxable income below the threshold amount and is also not subject to any wage limitation. Since the trust retained 25% of its DNI the trust is allocated the same amount as Larry was allocated, that being a loss of $11,750. Likewise it has no deduction and it is carried over to the following year.

D. ESBT

- 1. An electing small business trust (ESBT) is entitled to the deduction under Section 199A.
- 2. Any Section 199A deduction attributable to the assets in the S portion of the ESBT is to be taken into account by the S portion.
- 3. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under Sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT.
- 4. For purposes of determining whether the taxable income of an ESBT exceeds the threshold amount, the S portion and the non-S portion of an ESBT are treated as a single trust.

VIII. Deduction For Income Attributable To Domestic Production Activities Of Specified Agriculture Or Horticultural Cooperatives

A. Introduction

- 1. In the case of a taxpayer which is a specified agricultural or horticultural cooperative, there shall be allowed as a deduction an amount equal to 9 percent of the lesser of:
  - the qualified production activities income of the taxpayer for the taxable year, or
  - the taxable income of the taxpayer for the taxable year.
- 2. The deduction allowable for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer for the taxable year.

A. Introduction

- 3. The term “specified agricultural or horticultural cooperative” means an organization to which part I of subchapter T applies which is engaged in the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or in the marketing of agricultural or horticultural products.

- 4. A specified agricultural or horticultural cooperative shall be treated as having manufactured, produced, grown, or extracted in whole or significant part any agricultural or horticultural product marketed by the specified agricultural or horticultural cooperative which its patrons have so manufactured, produced, grown, or extracted.

- 5. The W-2 wages of the taxpayer shall be determined in the same manner except that such wages shall not include any amount which is not properly allocable to domestic production gross receipts.

A. Introduction

- 6. The taxable income of a specified agricultural or horticultural cooperative shall be computed without regard to any deduction relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions.
- 7. In the case of any eligible taxpayer who receives a qualified payment from a specified agricultural or horticultural cooperative, there shall be allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the deduction allowed which is allowed with respect to the portion of the qualified production activities income to which such payment is attributable and is identified by such cooperative in a written notice mailed to such taxpayer during the payment period.
- 8. The deduction allowed to any taxpayer shall not exceed the taxable income of the taxpayer determined without regard to the deduction. In addition, the taxable income of a specified agricultural or horticultural cooperative shall not be reduced by reason of that portion of any qualified payment as does not exceed the deduction allowable with respect to such payment.

A. Introduction

- 9. The term “qualified production activities income” for any taxable year means an amount equal to the excess (if any) of the taxpayer's domestic production gross receipts for such taxable year, over the sum of the cost of goods sold that are allocable to such receipts, and other expenses, losses, or deductions (other than the deduction allowed under this subsection), which are properly allocable to such receipts. The Secretary shall prescribe rules for the proper allocation of items for purposes of determining qualified production activities income. Such rules shall provide for the proper allocation of items whether or not such items are directly allocable to domestic production gross receipt

- 10. For purposes of determining costs, any item or service brought into the United States shall be treated as acquired by purchase, and its cost shall be treated as not less than its value immediately after it entered the United States. A similar rule shall apply in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts.

A. Introduction

- 11. In the case of any property that had been exported by the taxpayer for further manufacture, the increase in cost or adjusted basis shall not exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture.

- 12. The term “domestic production gross receipts” means the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of any agricultural or horticultural product which was manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the United States. Such term shall not include gross receipts of the taxpayer which are derived from the lease, rental, license, sale, exchange, or other disposition of land. It shall not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.

A. Introduction

- 13. In the case of oil related qualified production activities income, the proposal provides that the Section 199A(g) deduction is reduced by three (3%) percent of the least of the cooperative ’s oil related qualified production activities income, qualified production activities income, or taxable income (determined without regard to the cooperative’s Section 199A(g) deduction and any deduction allowable under Section 1382(b) and (c) (relating to patronage dividends, per -unit retain allocations, and nonpatronage distributions)) for the taxable year.

- 14. For this purpose, oil related qualified production activities income for any taxable year is the portion of qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof during the taxable year.

A. Introduction

- 15. The cooperative is treated as having manufactured, produced, grown, or extracted in whole or significant part any agricultural or horticultural products marketed by the cooperative if such items were manufactured, produced, grown, or extracted in whole or significant part by its patrons.

- 16. Domestic production gross receipts do not include any gross receipts of the cooperative derived from property leased, licensed, or rented by the taxpayer for use by any related person. In addition, domestic production gross receipts do not include gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of land.

- 17. The Act limits the definition of specified agricultural or horticultural cooperative to organizations to which part I of subchapter T applies that (1) manufacture, produce, grow, or extract in whole or significant part any agricultural or horticultural product , or (2) market any agricultural or horticultural product that their patrons have so manufactured, produced, grown, or extracted in whole or significant part.

A. Introduction

- 18. The definition no longer includes a cooperative solely engaged in the provision of supplies, equipment, or services to farmers or other specified agricultural or horticultural cooperatives.

- 19. All members of an expanded affiliated group are treated as a single corporation and the deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount, if any, of qualified production activities income. In addition, for purposes of determining domestic production gross receipts, if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group are treated as a single taxpayer during such period.

D. ESBT

- 20. In the case of a specified agricultural or horticultural cooperative that is a partner in a partnership, rules similar to the rules applicable to a partner in a partnership under Section 199A (f)(1) apply.

- 21. For a tax -exempt cooperative subject to tax on its unrelated business taxable income by Section 511, the proposal is applied by substituting unrelated business taxable income for taxable income where applicable.

- 22. The Section 199A(g) deduction is determined by only taking into account items that are attributable to the actual conduct of a trade or business.

D. ESBT

- 23. The Act provides that an eligible patron that receives a qualified payment from a specified agricultural or horticultural cooperative is allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the cooperative's deduction for qualified production activities income that is (i) allowed with respect to the portion of the qualified production activities income to which such payment is attributable , and (ii) identified by the cooperative in a written notice mailed to the patron during the payment period described in Section1382(d).

- 24. The patron's deduction of such amount may not exceed the patron's taxable income for the taxable year (determined without regard to such deduction but after taking into account the patron's other deductions under Section 199A(a)). A qualified payment is any amount that (i) is described in paragraph (1) or (3) of Section 1385(a) (i.e., patronage dividends and per-unit retain allocations), (ii)is received by an eligible patron from a specified agricultural or horticultural cooperative, and (iii)is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative.

D. ESBT

- 25. An eligible patron is:

- (i) a taxpayer other than a corporation, or
- (ii) another specified agricultural or horticultural cooperative. The cooperative cannot reduce its income under Section 1382 for any deduction allowable to its patrons under this rule (i.e., the cooperative must reduce its deductions allowed for certain payments to its patrons in an amount equal to the Section 199A(g) deduction allocated to its patrons

D. ESBT

- 26. The Act repeals the special deduction for qualified cooperative dividends. In addition, the proposal repeals the rule that excludes qualified cooperative dividends from qualified business income of a qualified trade or business. The proposal also clarifies that items f income excluded from qualified items of income, and thus excluded from qualified business income, do not include any amount described in Section 1385(a)(1)(i.e., patronage dividends).

- 27. Accordingly , qualified business income of a qualified trade or business includes any patronage dividend, per -unit retain allocation, qualified written notice of allocation, or any other similar amount received from a cooperative, provided such amount is otherwise a qualified item of income, gain, deduction, or loss(i.e., such amount is (i) effectively connected with the conduct of a trade or business within the United States, and (ii) included or allowed in determining taxable income for the taxable year).

D. ESBT

- 28. A reduced deduction for qualified payments received from a specified agricultural or horticultural cooperative In the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the deductible amount determined under Section 199A(b)(2) for such trade or business is reduced by the lesser of (1) nine percent of the amount of qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such specified agricultural or horticultural cooperative , or (2) 50 percent of the amount of W-2 wages with respect to such qualified trade or business that are properly allocable to such amount.

D. ESBT

- 29. The Act clarifies that the repeal of Section 199 for taxable years beginning after December 31, 2017, does not apply to a qualified payment received by a patron from a specified agricultural or horticultural cooperative in a taxable year beginning after December 31, 2017, to the extent such qualified payment is attributable to qualified production activities income with respect to which a deduction is allowable to the cooperative under former Section 199 for a taxable year of the cooperative beginning before January 1, 2018. Such qualified payment remains subject to former Section 199 and any Section 199 deduction allocated by the cooperative to its patrons related to such qualified payment may be deducted by such patrons in accordance with former Section 199. In addition, no deduction is allowed under Section 199A for such qualified payments.

Example

- Cooperative is a grain marketing cooperative with $5,250,000 in gross receipts during 2018 from the sale of grain grown by its patrons. Cooperative paid $4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations and another $1,000,000 in patronage dividends after the close of the 2018 taxable year. Cooperative has other expenses of $250,000 during 2018, including $100,000 of W-2 wages .Cooperative has domestic production gross receipts of $5,250,000 and qualified production activities income of $5,000,000for 2018. Cooperative's Section 199A(g)deduction is $50,000 and is equal to the least of nine percent of qualified production activities income ($450,000),nine percent of taxable income ($450,000),or 50 percent of W-2 wages ($50,000).

Example

- Cooperative passes through the entire Section 199A(g)deduction to its patrons. Accordingly, Cooperative reduces its $5,000,000 deduction allowable under Section 1382(b) and (c) (relating to the $1,000,000 patronage dividends and $4,000,000 per-unit retain allocations) by $50,000. Patron's grain delivered to Cooperative during 2018 is two percent of all grain marketed through Cooperative during such year. During 2019, Patron receives $20,000 in patronage dividends and $1,000 of allocated Section 199A (g) deduction from Cooperative related to the grain delivered to Cooperative during 2018.

Example

- Patron is a grain farmer with taxable income of $75,000 for 2019 (determined without regard to Section 199A) and has a filing status of married filing jointly. Patron's qualified business income related to its grain trade or business for 2019 is $50,000, which consists of gross receipts of $150,000 from sales to an independent grain elevator, per -unit retain allocations received from Cooperative during 2019 of $80,000, patronage dividends received from Cooperative during 2019 related to Cooperative 's 2018 net earnings of $20,000, and expenses of $200,000 (including $50,000 of W-2 wages).

Example

- The portion of the qualified business income from Patron's grain trade or business related to qualified payments received from Cooperative during 2019 is $10,000, which consists of per-unit retain allocations received from Cooperative during 2019 of $80,000, patronage dividends received from Cooperative during 2019 related to Cooperative's 2018 net earnings of $20,000, and properly allocable expenses of $ 90,000 (including $25,000 of W-2 wages).

- Patron's deductible amount related to the grain trade or business is 20 percent of qualified business income ($10,000)reduced by the lesser of nine percent of qualified business income related to qualified payments received from Cooperative ($900)or 50 percent of W-2 wages related to qualified payments received from Cooperative ($12,500)or $9,100. As Patron does not have any other qualified trades or business, the combined qualified business income amount is also $9,100. Patron's deduction under Section 199A for 2019 is $10,100, which consists of the combined qualified business income amount of $9,100, plus Patron's deduction passed through from Cooperative of $1,000.

IX. Rental Real Estate Activities

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- 1. The Service has finalized a proposed Revenue Procedure that it issued earlier this year. The Revenue Procedure provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for the purposes of the qualified business income deduction.

- 2. In Notice 2019-7, 2019-9 IRB 740, IRS issued a proposed version of a revenue procedure containing a safe harbor for treating a rental real estate enterprise as a trade or business solely for purposes of Section 199A.

- 3. The IRS has now finalized the safe harbor rules. The safe harbor is available to taxpayers who seek to claim the deduction under Section 199A with respect to a rental real estate enterprise as defined under "Rental real estate enterprise," below.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- 4. If the safe harbor requirements are met, the rental real estate enterprise will be treated as a single trade or business as defined in Section 199A(d) for purposes of applying the regs under Section 199A, including the application of the aggregation rules in Reg § 1.199A-4.

- 5. A relevant passthrough entity (RPE) includes a partnership (other than a publicly traded partnership) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. (Reg § 1.199A-1(b)(10)) RPEs may also use this safe harbor. In order to rely upon the safe harbor, taxpayers and RPEs must satisfy all of the requirements of the revenue procedure.

- 6. Failure to satisfy the requirements of this safe harbor does not preclude a taxpayer or IRS from otherwise establishing that an interest in rental real estate is a trade or business for purposes of Section 199A.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- 7. Rental Real Estate Enterprise

- a. Solely for purposes of the safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in a single property or interests in multiple properties.

- b. The taxpayer or RPE relying on the Revenue Procedure must hold each interest directly or through an entity disregarded as an entity separate from its owner under any provision of the Code.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- c. Except for those property interests described as "Excluded real estate arrangements" taxpayers and RPEs may either treat each interest in similar property held for the production of rents as a separate rental real estate enterprise or treat interests in all similar properties held for the production of rents as a single rental real estate enterprise.

- d. For purposes of applying the Revenue Procedure, properties held for the production of rents are similar if they are part of the same rental real estate category. The two types of rental real estate categories for the purpose of combining properties into a single rental real estate enterprise are residential and commercial. Thus, commercial real estate held for the production of rents may only be part of the same enterprise with other commercial real estate, and residential properties may only be part of the same enterprise with other residential properties.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- e. Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor, the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor.

- f. A taxpayer or RPE that chooses to treat its interest in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar commercial or all similar residential properties as a single rental real estate enterprise in a future year.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- g. An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. For purposes of the Revenue Procedure, mixed-use property is defined as a single building that combines residential and commercial units.

- h. Rental real estate enterprise that satisfies the requirements of this safe harbor is treated as a separate trade or business for purposes of applying Section 199A and the regs thereunder.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- 8. The Safe Harbor

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- 1. The determination to use this safe harbor must be made annually. Solely for the purposes of Section 199A, each rental real estate enterprise will be treated as a single trade or business if the following requirements are satisfied during the tax year with respect to the rental real estate enterprise:

- i. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise. If a rental real estate enterprise contains more than one property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated;

- ii. For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (as described under "Rental services" below) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive tax years that end with the tax year, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and

- iii. The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following:

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- hours of all services performed;
- description of all services performed;
- dates on which such services were performed; and
- who performed the services. If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor. Such records are to be made available for inspection at the request of IRS.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- b. The taxpayer or RPE attaches a statement to a timely filed original return (or an amended return for the 2018 tax year only) for each tax year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement, but the statement must list the required information separately for each rental real estate enterprise.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- c. The statement must include the following information:
  - A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise;
  - A description (including the address and rental category) of rental real estate properties acquired and disposed of during the tax year; and
  - A representation that the requirements of the Revenue Procedure have been satisfied.

- 9. Rental Services

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- a. Rental services for purpose of the Revenue Procedure include, but are not limited to:
  - advertising to rent or lease the real estate;
  - negotiating and executing leases;
  - verifying information contained in prospective tenant applications;
  - collection of rent;
  - daily operation, maintenance, and repair of the property, including the purchase of materials and supplies;
  - management of the real estate; and
  - supervision of employees and independent contractors.

- b. Rental services may be performed by owners, including owners of an RPE, or by employees, agents, and/or independent contractors of the owners.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- c. The term rental services does not include the following:
  - financial or investment management activities, such as arranging financing; procuring property;
  - studying and reviewing financial statements or reports on operations;
  - improving property under Reg § 1.263(a)-3(d); or hours spent traveling to and from the real estate.
- 10. Excluded Real Estate Arrangements

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- a. The following types of property may not be included in a rental real estate enterprise and are therefore not eligible for the safe harbor:
  - Real estate used by the taxpayer (including an owner or beneficiary of an RPE) as a residence under Section 280A(d).
  - Real estate rented or leased under a triple net lease. For purposes of the Revenue Procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to pay for maintenance activities for a property in addition to rent and utilities.
  - Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under Reg § 1.199A-4(b)(1)(i).
  - The entire rental real estate interest if any portion of the interest is treated as an SSTB under Reg § 1.199A-5(c)(2) (which provides special rules where property or services are provided to an SSTB).

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- b. The Revenue Procedure applies to tax years ending after December 31, 2017. Alternatively, taxpayers and RPEs may rely on the safe harbor set forth in Notice 2019-7 for the 2018 tax year.

- c. **The contemporaneous records requirement will not apply to tax years beginning prior to January 1, 2020**. However, IRS reminds taxpayers that they bear the burden of showing the right to any claimed deductions in all tax years.

A. Rental Real Estate Activities as a Trade or Business and Rental Real Estate Enterprise Safe Harbor – IRS Notice 2019 – 07; Rev Proc 2019-38, 2019-42 IRB; IR 2019-158, 9/24/2019

- 11. IRS FAQ Question 17 states that the deduction in association rental is not based on whether the taxpayer qualifies as a real estate professional. Rental real estate may constitute a trade or business for purposes of the QBI deduction if the rental real estate:
  - rises to the level of a trade or business under Section 162,
  - satisfies the safe harbor requirements under Notice 2019 – 07, or
  - meets the self-rental exception (the rental or licensee of property to a commonly controlled trade or business conducted either by the individual or RPE).

- Whether rental real estate rises to the level of a trade or business is a facts and circumstance examination.

- 12. Likewise, IRS FAQ 20 states that material participation of a partner or individual under Section 469 is not required for the QBI deduction. This is regardless of the taxpayer’s involvement in the trade or business.

B. Special Rule for Renting Property to a Related Persons

- 1. The rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing activity and the other trade or business are commonly controlled under proposed regulation 1.199A – 4(b)(1)(i). This rule allows taxpayers to aggregate their trade or businesses with the leasing or licensing of the associated rental or intangible property if the requirements of proposed regulation 1.199A – 4 are met.

- 2. Proposed Regulation 1.199 – 4 pertains to aggregation and will be discussed in a separate section.

Example

- Assume John has a dental practice in a C Corporation. His wife Joan owns the commercial building that she leases to John. The corporation pays all expenses as well as maintenance, taxes, insurance. The lease agreement is a triple net lease. Under the rules, the rental income that Joan receives will not qualify for the deduction under the final regulation. However, some tax planning can change this. The service takes the position that a single triple net lease is generally not a trade or business. The safe harbor provision will not work because triple net leases are barred. However, if the property were rented to a commonly controlled pass-through trade or business. It could qualify for the deduction.

Example

- Under the commonly controlled rules, the rental would qualify for the Section 199A deduction if Joan rented it to a trade or business force the same person or persons, directly or by attribution, owned 50% or more of both activities. Since the ownership of one spouse actually to the other spouse, John and Joe will be commonly controlled requirement. Presently, the real arrangement fails because the taxpayers must own the business directly or throw pastor to qualify. The existing rental agreement in a non-pastor does not meet the common control rule. John and Joan can form S corporation from the dental practice and renegotiate the terms of a lease to a traditional commercial property lease arrangement. By operating the dental practice as an S corporation, the rental automatically qualifies for the deduction. This assumes that taxable income of John and Joan either or below or within the threshold amounts based upon their filing status.

C. Other Rental Issues

- 1. The Service provides no bright line rule as to whether a land lease or a lease of unimproved land is a trade or business for purposes of the deduction.

- 2. As such, the issue as to whether a land lease or lease of unimproved land is a facts and circumstance examination.

X. Forms 8995 and 8995-A

X. Forms 8995 and 8995-A

- **1. Form 8995: Qualified Business Income Deduction.**
  - This is the simplified computation form will be used if the taxpayer has QBI, qualified REIT dividends and/or qualified PTP income.
  - The Taxpayer is not a patron a specified agricultural or horticultural cooperative

- a. There is a new worksheet added to provide a reasonable method to track and compute previously disallowed losses or deductions that should be included in the QB I deduction computation for the year allowed. The worksheet is titled Tracking Losses or Deductions Suspended by Other Provisions.

X. Forms 8995 and 8995-A

- **2. Form 8995 – A: Qualified Business Income Deduction**. This form will be used as follows:
  - The taxpayer has QBI, qualified REIT dividends and/or qualified PTP income.
  - The Taxpayer is not a patron a specified agricultural or horticultural cooperative

- **3. Schedules Associated with Form 8995 – A**: The Schedules associated with the form include the following:
  - Schedule A: Specified Service Trades or Businesses
  - Schedule B: Aggregation of Business Operations
  - Schedule C: Loss Netting and Carryforward
  - Schedule D: Special Rules for Patrons of Agricultural or Horticultural cooperative.

SECTION VI:

AMT AND OTHER TAXES

I. AMT and Other Taxes

A. AMT for 2024 (Rev. Proc. 2023 – 34)

- 1. For 2024, the AMT exemption amount will be as follows:

• Married filing joint and surviving spouse	$133,300
• Single individuals and HOH	$85,700
• Married Filing Separately	$66,650

- 2. For 2024, the amount used to determine the phase-out of the AMT exemption will be as follows:

• Married filing joint and surviving spouse	$1,218,700
• Single individuals and HOH	$609,350
• Married Filing Separately	$609,350

B. AMT for 2025 (Rev. Proc. 2024 – 40)

- 1. For 2025, the AMT exemption amount will be as follows:

• Married filing joint and surviving spouse	$137,000
• Single individuals and HOH	$88,100
• Married Filing Separately	$68,500

- 2. For 2025, the amount used to determine the phase-out of the AMT exemption will be as follows:

• Married filing joint and surviving spouse	$1,252,700
• Single individuals and HOH	$626,350
• Married Filing Separately	$626,350

C. Excess Taxable Income and AMT

- 1. For 2024, the excess taxable income above which the 28% tax rate applies will be: (Rev. Proc. 2023 – 34)

- Married filing joint and surviving spouse $ 232,600
- Single, HOH and married persons filing separately $116,300

- 2. For 2025, the excess taxable income above which the 28% tax rate applies will be: (Rev. Procl. 2024 – 40)

- Married filing joint and surviving spouse $239,100
- Single, HOH and married persons filing separately $119,550

D. Alternative Minimum Tax Exemption for a Child Subject to the Kiddie Tax

- 1. For 2024, a child for whom the kiddie tax applies the exemption for purposes of the alternative minimum tax may not exceed the sum of the child's earned income for the taxable year plus $9,250.

- 2. For 2025, a child for whom the kiddie tax applies the exemption for purposes of the alternative minimum tax may not exceed the sum of the child's earned income for the taxable year plus $9,550.

E. AMT Credit Carryforward.

- 1.The AMT credit carryforward can be used to the extent that the regular tax exceeds AMT. Since many taxpayers will avoid AMT in 2021, the credits may be usable sooner than later. However, the credits are not assignable.

Example

- **Vichich v. Comm., 146 TC 12**. Husband before his marriage to Wife exercised incentive stock options resulting in AMT liability which he reported on his tax return filed jointly with his first wife. The payment of the AMT liability generated an AMT credit carryforward. Husband's first wife died and he remarried (Wife 2). Husband subsequently died. On Wife 2's tax return she reported AMT credits derived from the deceased husband's AMT credit carryforward that she used to offset her income tax liability. The court agreed with the IRS the 2nd wife is not entitled to premarital credit carryforwards.

II. Kiddie Tax

A. General

- 1. The kiddie tax applies to a child if the child is:
  - Under the age of 18, regardless of whether earned income equals more than one half of the child support, or
  - That the child turned age 18, or
  - If the child was a full-time student between the ages of 19 and 23 before the end of the applicable tax year and the child's earned income for the year does not exceed one half of his or her support.
  - The child has at least one living parent at the close of the tax year;
  - The child possessed unearned income of more than $2,200; and
  - The child did not file a joint return.

A. General

- 2. Unearned income for these purposes is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered. It also includes distributions from qualified disability trusts. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.

- **3. SECURE Act**. The changes under the TCJA created a degree of unfairness causing increase in tax on certain children, including those who are receiving government payments which were characterized under income because they were survivors of deceased military personnel, first responders and emergency workers.

A. General

- a. As such, the SECURE Act changed the rules under the TCJA on December 20, 2019 by repealing the prior measures. Beginning in 2020, with an option to start retroactively in 2018 and 2019, the income of children is taxed under the pre- TCJA rules. In other words, the old rule now prevails.

B. Unearned Income of Minor Children Subject to Kiddie Tax Exemption

- 1. For 2024, the exemption from the kiddie tax for 2024 will be $2,600. A parent will be able to elect to include a child's income on the parent's return for 2024 if the child's income is more than $1,300 and less than $13,000. (Rev. Proc. 2023 – 34)

- 2. For 2025, the exemption from the kiddie tax for 2025 will be $2,600. A parent will be able to elect to include a child's income on the parent's return for 2025 if the child's income is more than $1,350 and less than $13,500. (Rev. Proc. 2024 – 40)

III. Tax On Net Investment Income

A. Tax for 2024

- 1. The 3.8% Net Investment Income (NII) Tax Is Imposed On The Lesser Of:
  - An Individual's NII For The Tax Year, Or
  - MAGI In Excess Of A Floor:
  - $200,000 For Single And Head Of Household;
  - $250,000 For Joint Filers And Surviving Spouses; Or
  - $125,000 For A Married Taxpayer Filing Separately (See Reg. Section 1411(A)(1) & (B); §1.1411- 2(B)(1); §1.1411-2(D)(1)).

- 2. The Act did not change the threshold requirements for the imposition of the net investment income tax. In other words, the above amounts will be applicable in 2021.

B. Credit Claims Against Net Investment Income

- 1. The foreign tax credit does not reduce the net investment income tax. (Toulouse v. Comm., 157 TC 49)

- 2. Application of Tax Treaties

Example

- **Christensen v. US., 132 AFTR2d 2023 – 5304 (Cr. Fed. Cl).** The Court of Federal Claims held that the tax treatment to the US and France does not allow for foreign tax credit against the net investment income tax. The court determined the treaty subjects its allowance of foreign tax credits to the provisions and limitations of the Internal Revenue Code relating to foreign tax credits including restrictions on the application of the credit. The net investment income tax is a restriction against the application of the credit.

IV. Additional Medicare Tax

A. General Rule

- 1. The 0.9% Additional Medicare Tax applies to your Medicare wages, Railroad Retirement Tax Act (RRTA) compensation, and self-employment income above a threshold amount.

- 2. Medicare wages and self-employment income are combined to determine if the taxpayer exceeds the thresholds shown below. A self employment loss cannot be considered for purposes of this tax. RRTA compensation should be separately compared to the thresholds.

- 3. The employer of the taxpayer is responsible for withholding the .9 additional Medicare tax on the taxpayers Medicare wages or RRTA compensation in excess of the thresholds in a calendar year.

- 4. The form to file his Form 8959.

B. Threshold Amounts

- 1. The threshold amounts are as follows:

B. Threshold Amounts

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household	$200,000
Qualifying surviving spouse	$200,000

B. Threshold Amounts

- 2. The threshold amounts are not adjusted for inflation.

V. Excess Advance Premium Tax Credit Repayment – Form 8962

A. Advanced Premium Tax Credits Required Form 8962 to be Attached To The Return.

Example

- **Sneed v. Comm., TC Summary 2023 – 11**. Taxpayer enrolled in health insurance for herself and to dependents through the marketplace. The taxpayer received advance premium tax credits on the basis of information in the application. Taxpayer did not attach a copy of Form 89 16: Premium Tax Credit to her return but later mailed it separately. The notice of deficiency determine the taxpayer was not eligible for the tax credit because her modified AGI exceeds 400% of the federal poverty level line in association with her family size. The form according to the court is required to reconcile the events payments in relation to the eligibility for the credit and income of the taxpayer with respect to the federal poverty level and family size.

B. News Release IR 2024 – 54: Correcting E-file Returns Rejected for Missing Form 8962.

- **1.** The IRS is reminding taxpayers that an e-filed tax return will be rejected if the taxpayer is required to reconcile advance payments of the premium tax credit (APTC) on Form 8962 [Premium Tax Credit (PTC)] but does not complete the form in their tax software and include it with the tax return submission. Taxpayers must file Form 8962 if any family member was enrolled in Marketplace health insurance and IRS records show that APTC was paid to their Marketplace insurance company.

- 2. The IRS has seen an increase in the number of taxpayers who are not including the required form when using tax software to file their returns. If a taxpayer's e-filed return is rejected due to a missing Form 8962, they may refile their complete return by completing and attaching Form 8962 or a written explanation of the reason for its absence.

SECTION VII:

PERSONAL TAX CREDITS

I. Child Tax Credit

A. Qualifications

- 1. To be a qualifying child of the tax year the defendant must be:
  - Be under age 17 at the end of the year
  - Be your son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister, half-brother, half-sister, or a descendant of one of these (for example, a grandchild, niece or nephew)
  - Provide no more than half of their own financial support during the year
  - Have lived with you for more than half the year
  - Be properly claimed as your dependent on your tax return
  - Not file a joint return with their spouse for the tax year or file it only to claim a refund of withheld income tax or estimated tax paid
  - Have been a U.S. citizen, U.S. national or U.S. resident alien

B. Amounts

- **1. 2024.** For taxable years beginning in 2024, the amount used to determine the amount of credit that may be refundable is $1,700. (Rev. Proc. 2023-34).
- **2. 2025**. For taxable years beginning in 2054, the amount used to determine the amount of credit that may be refundable is $1,700. (Rev. Proc. 2024-40).
- **Note**: There was no increase in the child tax credit over the prior year.
- **3. Phase out**. The phaseout of the child tax credit is annual income not exceeding $400,000 if married filing joint or $200,000 for all other filers.

C. Denial of Credit

- 1. No identifying number prior to filing a ritual turn cannot be amended by the taxpayer.

Example

- **Sowards v. Comm., TC Memo 2023 – 99**. The taxpayers filed a joint return for the years at issue. The taxpayers claimed the child tax credit and the additional child tax credit. The IRS notify the taxpayers that the credits were being disallowed as mathematical or clerical errors. At the time of filing, the returns did not have Social Security numbers for the children nor his spouse. After the taxpayer was notified of the disallowance, he received the Social Security numbers. The taxpayer amended his return accordingly. The taxpayer was not allowed to make the amendment as the tax identification numbers had not been issued before the due date for the filing of the return. The dependents were deemed undocumented immigrants and under Section 32 (m) and Section 6428 they were denied. It appears the court left the door open that if the identification numbers were received during the extension. The credits would’ve been allowed.

II. Adoption Tax Credit

A. Exclusion Amount on Form 1040

- 1. For 2024, the credit allowed for an adoption of a child with special needs will be $16,810. The maximum credit allowed for other adoptions will be the amount of qualified adoption expenses up to $16,810. (See Rev. Proc. 2023-34)

- 2. For 2024, the credit will begin to phase out for taxpayers with MAGI in excess of $ 252,150. The phaseout will be complete if MAGI is 292,150. (See Rev. Proc. 2023-34)

- 3. For 2025, the credit allowed for an adoption of a child with special needs will be $17,280. The maximum credit allowed for other adoptions will be the amount of qualified adoption expenses up to $17,280. (See Rev. Proc. 2024-40)

- 4. For 2025, the credit will begin to phase out for taxpayers with MAGI in excess of $259,190. The phaseout will be complete if MAGI is $299,190. (See Rev. Proc. 2024-40)

B. Employer Adoption Exclusion Amount

- 1. For 2024, the amount of employer that can be excluded from an employee’s gross income for the adoption of a child will be $16,810. Likewise, the adoption of a child with special needs has the same exclusionary.

- 2. For 2024, the amount of employer that can be excluded from an employee’s gross income for the adoption of a child will be $17,280. Likewise, the adoption of a child with special needs has the same exclusionary.

- 3. For 2024, for the excludable amount per employee’s gross income will begin to phase out for taxpayers with modified AGI in excess of $252,150 and the phaseout will be completed when modified AGI exceeds $292,150.

- 4. For 2025, for the excludable amount per employee’s gross income will begin to phase out for taxpayers with modified AGI in excess of $259,190 and the phaseout will be completed when modified AGI exceeds $299,190.

III. Child a Dependent Tax Credit

A. Current Rule

- 1. The credit is nonrefundable and families are eligible for the following:
  - 35% for taxpayers with adjusted gross income between $0 and $15,000
  - 20% to 35% for taxpayers earning between $15,000 and $43,000
  - 20% for those earning over $43,000 annually
- 2. The maximum expense that can be used to calculate the credit is $3000 for one qualifying person or $6000 for two or more eligible persons.

IV. Premium Tax Credit

A. Update – FS – 2024 – 04

- 1. The IRS has made some updates to its FAQ regarding the Premium Tax Credit.

- **2. Eligibility**. The eligibility requirements have been revised. A taxpayers eligible for the credit if they meet the following requirements:
  - Have household income that meets certain requirements (see Q7) or for 2021, you, or your spouse (if filing a joint return), received, or were approved to receive, unemployment compensation for any week beginning during 2021.
  - Do not file a Married Filing Separately tax return ((unless you qualify for a special rule that allows certain victims of domestic abuse and spousal abandonment to claim the Premium Tax Credit using the Married Filing Separately filing status (see Q9 and Q10);
  - Cannot be claimed as a dependent by another person; and

A. Update – FS – 2024 – 04

- In the same month, you, or a family member:
  - Enroll in coverage (excluding “catastrophic” coverage) through a Marketplace
  - Are not able to get affordable coverage through an eligible employer-sponsored plan that provides minimum value
  - (see Q11-15)
  - Are not eligible for coverage through a government program, like Medicaid, Medicare, CHIP or TRICARE
  - Pay the share of premiums not covered by advance credit payments

- **2. Income Limits**

A. Update – FS – 2024 – 04

- a. In general, individuals and families may be eligible for the Premium Tax Credit if their household income for the year is at least 100 percent but no more than 400 percent of the federal poverty line for their family size. For tax year 2021, if a taxpayer or the taxpayer's spouse (if filing a joint return), received, or was approved to receive, unemployment compensation for any week beginning during 2021, the amount of the taxpayer's household income is considered to be no greater than 133 percent of the federal poverty line for his or her family size and the taxpayer is considered to have met the household income requirements forbeing allowed a Premium Tax Credit.

A. Update – FS – 2024 – 04

- b. For tax years 2021 through 2025, Congress temporarily expanded eligibility for the Premium Tax Credit by eliminating the requirement that a taxpayer's household income may not be more than 400 percent of the federal poverty line. Under this rule, taxpayers with household income of more than 400 percent of the federal poverty line for their family size may be allowed to claim a Premium Tax Credit, if otherwise eligible (see Q5)

- **3. Changing Definition of Household Income**

A. Qualifications

- a. For purposes of the Premium Tax Credit, your household income is your modified adjusted gross income for the year plus that of every other member of your family (see Q6) who is required to file a federal income tax return. Modified adjusted gross income is the adjusted gross income on your federal income tax return plus any excluded foreign income, nontaxable Social Security benefits (including tier 1 railroad retirement benefits), and tax-exempt interest received or accrued during the taxable year. It does not include Supplemental Security Income (SSI).

A. Qualifications

- b. Regarding unemployment compensation, previously an eligible taxpayer was allowed to exclude from income up to $10,200 of unemployment compensation for the 2020 tax year. That exclusion also should have been excluded from modified AGI in doing the computation of the credit. Beginning in July 2021, the IRS review tax returns filed prior to the exclusion to identify taxpayers on which both the excludable unemployment compensation and access repayments were reported by the taxpayer. Taxpayer should have received letters from the IRS within 30 days of the adjustment informing them of what kind of adjustment was made. The adjustments could either be a refund, payment of IRS debt payment or an offset. If the cause of the excluded unemployment compensation, taxpayers are now eligible for deductions or credit not claimed on the original return an amended return for such should be filed for the year 2020.

A. Qualifications

- **4. Filing Status.** If the taxpayer was married and filed their return as married filing separately, the taxpayer is still eligible for the credit. This is particular the case under Section 1.36 B – 2 (b) (2) in association with certain victims of domestic abuse and spousal abandonment whereby filing as married filing separately they can claim the credit. In addition, the taxpayer must be living apart from the spouse at the time of filing return, the taxpayer is unable to file a joint return because they are a victim of domestic abuse or spousal abuse and a certified such on the return. The certification is at the top of Form 8962 which is attached to the return.

- **5. Affordability of Employer Coverage for Employees and Family Members.** If the taxpayer is an employee and the employer offers coverage which is known as an employer-sponsored plan in such plan is deemed affordable it refers to and satisfies coverage in association with the minimum value that does not exceed 8.39% of household income for 2024.

IV. Education Credits

A. American Opportunity Tax Credit

- 1. The amount of the credit available is capped at $2,500 associate with the cost of tuition and related expenses paid during the tax year. The taxpayer can receive a tax credit based on 100% of the first $2,000 of tuition and related expenses. This does include course material paid during the tax year and 25% of the next $2,000 of tuition and related expenses paid during the tax year. 40% of the credit is refundable.

- 2. Taxpayers will not be allowed to claim the credit or the lifetime learning credit or the tuition deduction unless the taxpayer receives a Form 1098 – T from the educational institution. No American opportunity tax credit will be allowed unless the taxpayer includes the employer identification number of any educational institution to which the qualified tuition and related expenses were paid for education furnished in academic education.

A. American Opportunity Tax Credit

- 3. Verification similar to the earned income credit will be required each year that taxpayers must include in the return prior to taking the credit.

- 4. The taxpayer has the burden to show that the dependent student was enrolled at least half-time and eligible education institution in order to receive the education credit. The fact that the student receives a Form 1098 – T is not enough evidence that they are entitled to the deduction. (Lee and Martin v Comm. TCM 2017 – 73).

- 5. If this credit was denied or reduced for any reason other than a math or clerical error, Form 8862: Information to Claim Certain Credits at the Disallowance is still required to be attached to the return.

B. Lifetime Learning Credit

- 1. The Credit Is Nonrefundable. The Maximum Benefit Is $2,000 (20% Of First $10,000 In Qualified Expenses) Per Return. The student must be enrolled particular class is an eligible educational institution, take higher education courses to get the degree or other recognized educational credit or to get or improve job skills and be enrolled for at least one academic timeframe beginning in the tax year.

- 2. The academic timeframe can be a trimester, semester or quarterly basis and can include summer school.

C. Income Limitations for both Credits

- 1. For both credits an, there is a phaseout or reduction in the amount of the credit. Based upon the taxpayer's modified AGI. That is between $80,000 and $90,000 or $160,000 and $180,000 if the taxpayer is married filing jointly.

- 2. Both credits remain to be claimed on Form 8863.

D. Unreported Income and Estimated Income can Impact on the Credit

- 1. Unreported income can impact if not eliminate the education credit.

Example

- **Trice v. Comm., TC Memo 2023 – 15**. Taxpayer had failed to report Social Security disability benefits of which the IRS showed the taxpayer had received. Taxpayer admitted she did receive said benefits and should have reported any 5% of payments as gross income less deductions for work or other adjustments and for Medicare premium. The taxpayer claimed the Lifetime Learning credit in the full amount such amount is reduced to the extent disability payments cost her modified AGI to trigger the limits on personal tax credit.

V. Earned Income Credit

A. Eligibility Requirements

- 1. The taxpayers investment income must be less than $11,600 in 2024. (Rev Proc. 2023 – 34)
- a. For 2025, the investment income must be less than $11,950. (Rev. Proc. 2024 – 40)
- 2. The taxpayer must not have filed a Form 2555: Foreign Earned Income or claim any foreign earned income exclusion.
- 3. The taxpayer claiming the credit without any qualifying children must be between the ages of 25 and 65. If the taxpayer is claiming jointly without a child, only one spouse needs to meet the age requirement.
- 4. The taxpayer can still qualify for the credit if they are separated but still married. The taxpayers must not file a joint return and the child must meet the definition of a qualifying child including living with the taxpayer for more than half the year and the taxpayer and your spouse must not have live together during the last 6 months of the year or are subject to a written separation agreement or decree.

B. 2024 EIC Credit

- 1. For the 2024 tax year (taxes filed in 2025), the earned income credit will range from $632 to $7,830, depending on your filing status and how many children you have. Below are the maximum 2024 earned income tax credit amounts, plus the most you can earn before losing the benefit altogether.

B. 2024 EIC Credit

Number of children	Maximum earned income tax credit	Max AGI, single or head of household filers	Max AGI, married joint filers
0	$632	$18,591	$25,511
1	$4,213	$49,084	$56,004
2	$6,960	$55,768	$62,688
3 or more	$7,830	$59,899	$66,819

C. 2025 EIC Credit

- 1. For the 2025 tax year (taxes filed in 2065), the earned income credit will range from $649 to $8,046, depending on your filing status and how many children you have. Below are the maximum 2025 earned income tax credit amounts, plus the most you can earn before losing the benefit altogether.

C. 2025 EIC Credit

Number of children	Maximum earned income tax credit	Max AGI, single or head of household filers	Max AGI, married joint filers
0	$648	$19,104	$26,2141
1	$4,328	$50,434	$57,554
2	$7,152	$57,310	$64,430
3 or more	$8,490	$61,555	$68,675

VI. Energy Efficient Phone Improvement Credit

A. General Rule

- 1. The Inflation Reduction Act of 2022 amended the credits for energy efficient home improvements under Section 25C of the Internal Revenue Code and the residential energy property under Section 25D of the Code.
- 2. As amended, the energy efficient home improvement credit is increased for years after 2022, with an annual credit of generally up to $1,200. There will be no lifetime limit.
- 3. Beginning January 1, 2023, the amount of the credit is equal to 30% of the sum of amounts paid by the taxpayer for certain qualified expenditures, including
  - qualified energy efficiency improvements installed during the year,
  - residential energy property expenditures during the year, and
  - home energy audits during the year.

A. General Rule

- 4.There are limits on the allowable annual credit and on the amount of credit for certain types of qualified expenditures.

- 5. The maximum credit you can claim each year is:
  - $1,200 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.

- **Note**: In essence the maximum could be $3,200 per tax year.

A. General Rule

- 6. The credit has no lifetime dollar limit. You can claim the maximum annual credit every year that you make eligible improvements until 2033.
- 7. The credit is nonrefundable, so you can't get back more on the credit than you owe in taxes. You can't apply any excess credit to future tax years.
- 8. The credit is allowed for qualifying property placed in service on or after January 1, 2023, and before January 1, 2033.
- 9. In order to qualify for the credit the improvements must be the taxpayer’s main home which is the home generally where the taxpayer resides most of the time. In addition, the energy efficient home improvement credit is assessed to the home located United States it must be also an existing home that the taxpayer either improves or adds onto. It cannot be a new home.
- 10. The following energy efficient home improvements are eligible for the Energy Efficient Home Improvement Credit:

A. General Rule

- Building envelope components satisfying the energy efficiency requirements
  - exterior doors (30% of costs up to $250 per door, up to a total of $500);
  - exterior windows and skylights (30% of costs up to $600); and
  - insulation materials or systems and air sealing materials or systems (30% of costs).
- Home energy audits (30% of costs up to $150)

A. General Rule

- Residential energy property (30% of costs, including labor, up to $600 for each item) satisfying the energy efficiency requirements
  - central air conditioners;
  - natural gas, propane, or oil water heaters;
  - natural gas, propane, or oil furnaces and hot water boilers; and
  - improvements to or replacements of panelboards, sub-panelboards, branch circuits, or feeders that are installed along with building envelope components or other energy property enabled its installation and use.

- Heat pumps and biomass stoves and biomass boilers (30% of costs, including labor) satisfying the energy efficiency requirements
  - electric or natural gas heat pump water heaters;
  - electric or natural gas heat pumps; and
  - biomass stoves and biomass boilers.

B. Rebates – IR 2024 – 113; Announcement 2024 – 19

- 1. Taxpayers who receive rebates for the purchase of energy efficient homes will not include the value of the rebates as income on their tax returns. However, the taxpayers will need to reduce the basis of the property when they sell it by the amount of the rebate.

B. Rebates – IR 2024 – 113; Announcement 2024 – 19

- 2. Specifically, the following is noteworthy:
  - A rebate paid at the time of sale is not included in a purchaser's cost basis under Sec. 1012, the announcement said. For example, if the purchaser receives a $500 rebate at the time of sale of eligible property with a sales price of $600, then the purchaser's cost basis in the property is $100, not $600.
  - The amount of a rebate provided later constitutes an adjustment to basis under Sec. 1016. For example, if a purchaser spends $600 to buy eligible property in 2023 but later receives a $500 rebate, then the purchaser's cost basis is reduced to $100 from $600 when the rebate is provided.
  - The payer of a rebate is not required to file an information return with the IRS or provide a statement to the purchaser to report the payments of rebate amounts to the purchaser, per Sec. 6041.
  - Rebate payments made directly to a business taxpayer in connection with the business taxpayer's sale of goods or provision of services to a purchaser are not excluded from that taxpayer's gross income under Sec. 61.

B. Rebates – IR 2024 – 113; Announcement 2024 – 19

- 3. Taxpayers who receive rebates under the DOE home energy rebate programs and who are also eligible for the Sec. 25C credit must reduce the amount of the amount of qualified expenditures used to calculate credit by the amount of the rebate. For example, if a taxpayer receives a $100 rebate for a $400 product, then the 30% credit applies to the remaining $300, for a credit of $90.

C. Revenue Procedure 2024 – 31 Qualified Manufacturers Required Registration

- 1. The Revenue Procedure provides guidance on qualified manufacturers registering in the agreement process with respect to certifying that materials provided in association with the energy efficient home improvement credit meet the requirements for taxpayer to obtain the credit. The registration will be conducted via the IRS energy credits online portal.

- 2. Manufacturers will have until April 30, 2025 to complete the registration process and they would be deemed to be qualified for the 2020 for tax filing season.

- 3. The Revenue Procedure also details for qualified manufacturers to obtain product identification numbers (pin) numbers in association with their registration.

VIII. Residential Clean Energy Property Credits

A. General Rule

- 1. The residential clean energy property credit is a 30-percent credit for certain qualified expenditures made by a taxpayer for residential energy efficient property.

- 2. The Act extended the residential clean energy property credit through 2034.

- 3. The following residential clean energy expenditures are eligible for a Residential Clean Energy Property Credit of 30% of the cost:
  - solar electric property expenditures (solar panels);
  - solar water heating property expenditures (solar water heaters);
  - fuel cell property expenditures;
  - small wind energy property expenditures (wind turbines);
  - geothermal heat pump property expenditures; and
  - battery storage technology expenditures.

A. General Rule

- **4. Roofing Expenditure**. Some solar roofing tiles and solar roofing shingles serve as solar electric collectors while also performing the function of traditional roofing, serving both the functions of solar electric generation and structural support MAY qualify for the credit.

- 5. A taxpayer may include the labor costs properly allocable to the onsite preparation, assembly, or original installation of the qualified property and for piping or wiring to interconnect the qualifying property to the home.

B. Qualifications. The credit can be claimed for qualifying expenditures incurred for either an existing home or a newly constructed home.

- 1. The taxpayer may claim the credit for a purpose to the main home and whether they own it or rent it. Again, the main home is determine where the taxpayer lives for the mower majority of the time and it must in the property must be located in the United States.
- 2. The taxpayer cannot claim the credit if they are the landlord.
- 3. If the taxpayer uses the property solely for business purposes, the credit cannot be claimed. However if the taxpayer used the home partly for business the maximum amount of the credit available if the business use is less than 20% would be the full amount of the credit. However if the business use of the property is more than 20% is based on the shared expenses allocable to non-business use.

B. Qualifications. The credit can be claimed for qualifying expenditures incurred for either an existing home or a newly constructed home.

- 4. There is no overall dollar limit for the Residential Clean Energy Property Credit.

- 5. The credit is generally limited to 30% of qualified expenditures made for property placed in service beginning in 2022 through 2032.

- 6. Qualified expenses include the costs of new clean energy property including:
  - Solar electric panels
  - Solar water heaters
  - Wind turbines
  - Geothermal heat pumps
  - Fuel cells
  - Battery storage technology (beginning in 2023)

- Note: Used clean energy property is not eligible for the credit.

B. Qualifications. The credit can be claimed for qualifying expenditures incurred for either an existing home or a newly constructed home.

- 7. Qualified expenses may include labor costs for onsite preparation, assembly or original installation of the property and for piping or wiring to connect it to the home.

- 8. Traditional building components that primarily serve a roofing or structural function generally don't qualify. For example, roof trusses and traditional shingles that support solar panels don't qualify, but solar roofing tiles and solar shingles do because they generate clean energy.

- 9. The credit allowed for fuel cell property expenditures is 30% of the expenditures up to a maximum credit of $500 for each half kilowatt of capacity of the qualified fuel cell property.

- 10. The issue on rebates discussed previously under Rebates – IR 2024 – 113; Announcement 2024 – 19 applies here as well.

IX. Clean Vehicle Credits – TD 9995; IR 2014 – 131

A. General Rule

- 1. The residential clean energy property credit is a 30-percent credit for certain qualified expenditures made by a taxpayer for residential energy efficient property.

- 2. The Act extended the residential clean energy property credit through 2034.

- 3. The following residential clean energy expenditures are eligible for a Residential Clean Energy Property Credit of 30% of the cost:
  - solar electric property expenditures (solar panels);
  - solar water heating property expenditures (solar water heaters);
  - fuel cell property expenditures;
  - small wind energy property expenditures (wind turbines);
  - geothermal heat pump property expenditures; and
  - battery storage technology expenditures.

A. General Rule

- **4. Roofing Expenditure**. Some solar roofing tiles and solar roofing shingles serve as solar electric collectors while also performing the function of traditional roofing, serving both the functions of solar electric generation and structural support MAY qualify for the credit.

- 5. A taxpayer may include the labor costs properly allocable to the onsite preparation, assembly, or original installation of the qualified property and for piping or wiring to interconnect the qualifying property to the home.

B. Qualifications. The credit can be claimed for qualifying expenditures incurred for either an existing home or a newly constructed home.

- 1. The taxpayer may claim the credit for a purpose to the main home and whether they own it or rent it. Again, the main home is determine where the taxpayer lives for the mower majority of the time and it must in the property must be located in the United States.

- 2. The taxpayer cannot claim the credit if they are the landlord.

- 3. If the taxpayer uses the property solely for business purposes, the credit cannot be claimed. However if the taxpayer used the home partly for business the maximum amount of the credit available if the business use is less than 20% would be the full amount of the credit. However if the business use of the property is more than 20% is based on the shared expenses allocable to non-business use.

B. Qualifications. The credit can be claimed for qualifying expenditures incurred for either an existing home or a newly constructed home.

- 4. There is no overall dollar limit for the Residential Clean Energy Property Credit.

- 5. The credit is generally limited to 30% of qualified expenditures made for property placed in service beginning in 2022 through 2032.

- 6. Qualified expenses include the costs of new clean energy property including:
  - Solar electric panels
  - Solar water heaters
  - Wind turbines
  - Geothermal heat pumps
  - Fuel cells
  - Battery storage technology (beginning in 2023)

- Note: Used clean energy property is not eligible for the credit.

B. Qualifications. The credit can be claimed for qualifying expenditures incurred for either an existing home or a newly constructed home.

- 7. Qualified expenses may include labor costs for onsite preparation, assembly or original installation of the property and for piping or wiring to connect it to the home.
- 8. Traditional building components that primarily serve a roofing or structural function generally don't qualify. For example, roof trusses and traditional shingles that support solar panels don't qualify, but solar roofing tiles and solar shingles do because they generate clean energy.
- 9. The credit allowed for fuel cell property expenditures is 30% of the expenditures up to a maximum credit of $500 for each half kilowatt of capacity of the qualified fuel cell property.
- 10. The issue on rebates discussed previously under Rebates – IR 2024 – 113; Announcement 2024 – 19 applies here as well.

XI. Clean Vehicle Credits – TD 9995; IR 2014 – 131

A. General Rule

- 1. The IRS has issued final regulations for the new and previously on clean vehicle credit. If a taxpayer purchases and places in service a new plug-in electric vehicle or fuel-cell vehicle in 2023 or after the taxpayer may qualify for a clean vehicle credit. At the time of sale, the seller must give the taxpayer information about the vehicles qualifications and the seller must register online and report the same to the IRS. If this does not occur the vehicle will not be eligible for the credit.

- 2. A taxpayer may qualify for a credit up to $7,500 under Section 30D if you buy a new, qualified plug-in EV or fuel cell electric vehicle (FCV). The Inflation Reduction Act of 2022 changed the rules for this credit for vehicles purchased from 2023 to 2032. In some instances, the maximum credit is reduced to $3750.

A. General Rule

- 3. To qualify, you must:
  - Buy it for your own use, not for resale
  - Use it primarily in the U.S.

- 4. To qualify for the credit a vehicle must :
  - Have a battery capacity of at least 7 kilowatt hours
  - Have a gross vehicle weight rating of less than 14,000 pounds
  - Be made by a qualified manufacturer.
  - FCVs do not need to be made by a qualified manufacturer to be eligible. (See Revenue Procedure 2022 – 42)
  - Undergo final assembly in North America
  - Meet critical mineral and battery component requirements (as of April 18, 2023).

A. General Rule

- 5. The sale qualifies only if:
  - You buy the vehicle new
  - The seller reports required information to you at the time of sale and to the IRS.
  - Sellers are required to report your name and taxpayer ID number to the IRS for the taxpayer to be eligible to claim the credit.

- 6. The vehicle's manufacturer suggested retail price (MSRP) can't exceed:
  - $80,000 for vans, sport utility vehicles and pickup trucks
  - $55,000 for other vehicles

A. General Rule

- 7. The MSRP is the retail price of the automobile suggested by the manufacturer, including manufacturer installed options, accessories and trim but excluding destination fees. It is not necessarily the price paid.

- 8. The taxpayer can find your vehicle's weight, battery capacity, final assembly location (listed as “final assembly point”) and VIN on the vehicle's window sticker.

- 9. In addition, an eligible vehicle can be ascertained by going to www.fueleconomy.gov. The link is also on the IRS website.

A. General Rule

- 10. In addition, your modified adjusted gross income (AGI) may not exceed:
  - $300,000 for married couples filing jointly
  - $225,000 for heads of households
  - $150,000 for all other filers
- Note: The taxpayer can use their modified AGI from the year you take delivery of the vehicle or the year before, whichever is less. If your modified AGI is below the threshold in 1 of the two years, you can claim the credit.
- 11. The credit is nonrefundable, so you can't get back more on the credit than you owe in taxes. You can't apply any excess credit to future tax years.

B. Amount of Credit

- 1. The amount of the credit depends upon when the taxpayer placed the vehicle in service regardless of the purchase date. Placed in service refers to the date the taxpayer took delivery of the vehicle.

- 2. For vehicles placed in service January 1 to April 17, 2023:
  - $2,500 base amount
  - Plus $417 for a vehicle with at least 7 kilowatt hours of battery capacity
  - Plus $417 for each kilowatt hour of battery capacity beyond 5 kilowatt hours
  - Up to $7,500 total

- 3. In general, the minimum credit will be $3,750 ($2,500 + 3 times $417), the credit amount for a vehicle with the minimum 7 kilowatt hours of battery capacity.

B. Amount of Credit

- 4. For vehicles placed in service April 18, 2023 and after: Vehicles will have to meet all of the same criteria listed above, plus meet new critical mineral and battery component requirements for a credit up to:
  - $3,750 if the vehicle meets the critical minerals requirement only
  - $3,750 if the vehicle meets the battery components requirement only
  - $7,500 if the vehicle meets both

- 5. A vehicle that doesn't meet either requirement will not be eligible for a credit., Specifically, the final assembly of the vehicle must occur in north America. Also to clarify, no credit will be allowed unless the taxpayer includes the vehicle identification number on the tax return for the tax year that they are claiming the credit.

B. Amount of Credit

- 6. To claim the credit the taxpayer will file Form 8936: Qualified Plug-in Electronic Drive Motor Vehicle Credit (including Qualified 2 Wheeled Plug-in Electronic Vehicles) Tuesday

C. Updates to n New, Previously Owned Clean Vehicle and Commercial Clean vehicle Credit Updates – FS – 2024 – 14; IR 2024 – 111

- 1. As part of the eligibility for the credit the VIN of a new clean vehicle is required to be included on Form 8936: Clean Vehicle all Credits when the tax return is filed.

- 2. For vehicle sales occurring in 2023 caller sellers must file reports that the vehicle is eligible for the credit by February 15, 2024. For sales occurring in 2024 in later years, sellers must file the report within three days of the date of the sale or the IRS Energy Credit Online vehicle. (See Rev. Proc. 2024 – 12)

C. Updates to n New, Previously Owned Clean Vehicle and Commercial Clean vehicle Credit Updates – FS – 2024 – 14; IR 2024 – 111

- 3. Not later than the time of sale, the registered dealer must provide the buyer with a written disclosure containing the following information under penalty of perjury:
  - The MSRP of the new clean vehicle or the sale price of the previously owned clean vehicle.
  - The maximum amount of the credit allowable and any other incentive available for the purchase of such vehicle.
  - The amount provided by the dealer to you as a condition of you making the transfer election.
  - The modified AGI limitations provided in section 30D(f)(10) (in the case of a new clean vehicle) or section 25E(b)(2) (in the case of a previously owned clean vehicle), as applicable.

- 4. For previously owned clean vehicles, certification that:
  - The model year of the vehicle is at least two years prior to the calendar year of sale; and
  - That the transfer is the first transfer of the vehicle since Aug. 16, 2022, to a person other than the person with whom the original use of such vehicle commenced.

C. Updates to n New, Previously Owned Clean Vehicle and Commercial Clean vehicle Credit Updates – FS – 2024 – 14; IR 2024 – 111

- 5. Not later than the time of sale, the registered dealer must also provide you a copy of the seller report submitted for the vehicle (See Topic B FAQ 9 and Topic D FAQ 2) and confirmation of the successful submission of the report through IRS Energy Credits Online.

- 6. Dealers are not required to verify purchase income for a credit transfer or advance payments. They are also not required to repay the advance payment if the purchaser exceeds the income limitations. However, dealers are required to disclose information about the applicable income limits to the purchaser who must attest that he or she expects to qualify for the credit.

SECTION VIII:

ESATATES, GIFTS AND TRUSTS

I. Estate Tax Update

A. Estate Tax Exclusion Amount

- 1. For 2024, the estate exclusion will be $13,610,000. (Rev. Proc. 2023 – 34)
- 2. For 2025, the estate exclusion will be $13,990,000. (Rev. Proc. 2024 – 40)

B. Interest on Certain Portion of the Estate Tax Payable in Installments

- 1. For 2024, the dollar amount used to determine the portion will be $1,850,000. (Rev. Proc. 2023 – 34)

- 1. For 2025, the dollar amount used to determine the portion will be $1,900,000. (Rev. Proc. 2024-40)

C. Valuation of Qualified Real Property in Decedent's Gross Estate – Section 2032 A

- 1. For an estate of a decedent dying in 2024, the executor can elect to use special use valuation method under Section 2032A for qualified real property. The aggregate decrease in the value of said real property resulting from the election cannot exceed $1,390,000. (Rev. Proc. 2023 – 34)

- 2. For an estate of a decedent dying in 2025, the executor can elect to use special use valuation method under Section 2032A for qualified real property. The aggregate decrease in the value of said real property resulting from the election cannot exceed $1,420,000. (Rev. Proc. 2024-40)

II. Deceased Spouse Unused Exemption (DSUE)

A. Overview

- 1. The surviving spouse may utilize the DSUE in addition to their own exemption amount. The deceased spouse's estate must make an election to have the portability provisions apply. Executors intending to make the election must timely file a complete and properly prepared Form 706, including extensions, irrespective of whether or not the gross estate has a value in excess of the exclusion amount or is otherwise not obligated to file Form 706.
- a. A complete and properly prepared Form 706 includes filling out the section designated to determine whether or not the portability feature has been elected as well as the calculation of the DSUE.
- b. For purposes of electing the portability, Form 706 is considered complete and properly prepared if the return is prepared in accordance with the instructions for the Estate Tax Return.

A. Overview

- c. It should be noted the value of the marital deduction property and show reduction property is not required to be reported. However, executors must include the description, ownership, and the beneficiary of marital or charitable deduction property along with all other information necessary to establish the right of the state to such deductions.

- d. The value of marital deduction property or charitable deduction property is required if:
  - The value of such property relates to, is affected by, or is needed to determine the value passing from the decedent to another recipient;
  - The value of such property is needed to determine the estate's eligibility for the provisions of Sections 2032,2032A or another provision;
  - Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property charitable deduction property; or
  - A partial disclaimer or partial qualified terminable interest property election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

A. Overview

- 2. Computation of DSUE. The DSUE of a decedent is the lesser of the following:
  - The basic exclusion amount in effect or the year in which the decedent died or
  - The decedent's applicable exclusion amount less the sum of the amount of the taxable state and the amount of any adjusted taxable gifts of the decedent which together is the amount on which the tentative tax on the estate is determined.

- a. The determination of the DSUE is based last deceased spouse of the surviving spouse if a surviving spouse remarries and then divorces the subsequent death divorced spouse does not end the status of a privacy spouse as the last deceased spouse of a surviving spouse.

B. IRS Provides Simplified Method for Extending Portability Election - Rev Proc 2022-32, 2022-30 IRB

- 1. The IRS has released a procedure that provides a new, simplified method for obtaining an extension of time to make a "portability" election. A portability election allows a surviving spouse to apply a deceased spouse's unused exclusion (DSUE) amount to their own transfers during life or at death.

- 2. The new procedure provides a new simplified method for certain estates to use to obtain an extension of time to elect portability of a DSUE amount. The procedure 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 and the decedent has a surviving spouse.

B. IRS Provides Simplified Method for Extending Portability Election - Rev Proc 2022-32, 2022-30 IRB

- 3. Under the new procedure, an extension request must be made on or before the fifth anniversary of the decedent's death. This simplified method, which doesn't require a user fee, should be used in lieu of the letter ruling process.

- 4. In 2017, the IRS published Rev Proc 2017-34, 2017-26 IRB 1282, which provided a simplified method for obtaining an extension of time to make a portability election for an estate wasn't required to file an estate tax return and the decedent had a surviving spouse. This procedure was to be used in lieu of the letter ruling process and was available up to the second anniversary of the decedent's date of death.

B. IRS Provides Simplified Method for Extending Portability Election - Rev Proc 2022-32, 2022-30 IRB

- 5. Since the publication of Rev Proc 2017-34, the IRS issued numerous letter rulings granting an extension of time to elect portability in situations in which the decedent's estate was not required to file an estate tax return and the time for obtaining relief under the simplified method had expired. According to the IRS, these requests place a significant burden on the IRS's resources. Therefore, the new procedure supersedes Rev Proc 2017-34.

- 6. Rev Proc 2022-32 is effective July 8, 2022, and it is the exclusive method for obtaining an extension of time for estates.

C. Final Regs. Eliminate Clawback – TD 9884

- 1. The IRS has released final regs that adopt the special rule provided in the proposed regs issued in November 2018 in cases where the portion of the credit against the estate tax that is based on the BEA is less than the sum of the credit amount attributable to the BEA allowable in computing gift tax payable.

- 2. Under Section 2001(b), to determine the amount of federal estate tax to be paid at death, the gift and estate tax provisions apply a unified rate schedule to the taxpayer's cumulative taxable gifts and taxable estate on death to arrive at a net tentative tax. The net tentative tax then is reduced by a credit based on the applicable exclusion amount (AEA), which is the sum of the basic exclusion amount (BEA) and, if applicable, the deceased spousal unused exclusion (DSUE) amount.

C. Final Regs. Eliminate Clawback – TD 9884

- 3. Section 11061 of the Tax Cuts and Jobs Act, amended Section 2010 to provide that for decedents dying and gifts made after December 31, 2017, and before January 1, 2026, the BEA is increased from $5 million, adjusted for inflation, to $10 million adjusted for inflation (Increased BEA). On January 1, 2026, the BEA will revert to $5 million as adjusted for inflation.

- 4. On November 23, 2018, the IRS issued proposed regs (Preamble to Prop Reg REG-106706-18), which provided a “special rule,” that ensured that a decedent's estate would not be inappropriately taxed with respect to gifts that were sheltered from gift tax by the increased BEA when made.

C. Final Regs. Eliminate Clawback – TD 9884

- 5. The final regs adopt the proposed regs but provide additional examples illustrating how the rules will operate.

- 6. The final regs provide that in computing the estate tax, the increased BEA is applied first against the decedent’s taxable gifts. To the extent any BEA remains at death, it is applied against the decedent’s estate. Therefore, in the case of a decedent who had made enough gifts to cause the total BEA allowable in the computation of gift tax payable to equal or exceed the date of death BEA (as adjusted for inflation), there is no remaining BEA available to be applied to reduce the estate tax.

III. Basis and Step Up

A. Rev. Rul. 2023 – 2

- 1. If the assets of an irrevocable grantor trust are not included in the grantor's gross estate then upon the decedent’s death, those assets do not get a Section 1014 basis step-up even though the grantor trust's owner is liable for federal income tax on the trust's income.

- 2. 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 Section 1014(b), and are not considered to have been acquired from or to have passed from the decedent under Section 1014(a).

- 3. This means that the step-up basis which generally applies the fair market value at the time someone dies to property that a taxpayer receives from the decedent, does not apply.

IV. Final Regulations on GST Exemption

A. Rule

- 1. The service has issued final regulations provide guidance on when and how taxpayers contain an extension of time to make certain GST exempt allocations and elections under Section 2642 (g) (1).
- 2. As a result of the final regulations relief under this code section will no longer be granted on or after May 6, 2024. However, private letter ruling relief will still be granted.
- 3. The final regulation removed a proposal that would prohibit relief to revoke a prior GST election.. The final regulation would allow relief to revoke a GST election if it was erroneous in nature.
- 4. The final relations provide additional details relate to affidavits when requesting Private Letter Ruling for GST purposes.
- 5. To receive relief the taxpayer must show that acted reasonably and in good faith and that they are not attempting to benefit from hindsight and that it would not prejudice the interest the government if relief were granted.

V. Income Included In Estate

A. Death Benefit Proceeds from Life Insurance

- 1. The gross estate of a decedent does not include death benefit proceeds from life insurance policies that were acquired by an irrevocable trust that the decedent created and for which premiums were funded with valid loans. Specifically, in order to be includable there has got to be a retention of incidents of ownership. (See Becker v. Comm., TC Memo 2024 – 89)

B. Uncashed Check Includable in Estate

- 1. Gift checks to family members that remained uncashed at the time of death were not completed gifts. As a result, the checks' value should have been included in his gross estate, according to the Third Circuit.

Example

- **Estate of DeMuth, Jr. (CA 3) 132 AFTR2d 2023 – 5122**. Prior to the death of their father, his agent wrote out 11 checks to family members totaling $464,000 and either had them mailed or personally delivered to said family members. 10 of the 11 checks were paid from the decedent's investment account after his death. The executor filed an estate return that excluded the value of the 11 checks. The IRS determined the taxpayer should've included 10 of the 11 checks that did not clear before his death and issued a notice of deficiency accordingly. The estate appealed previously to the Tax Court. The Service in that case agreed to exclude three of the checks as they had been deposited on the date the taxpayer died. The estate argued remaining seven checks were completed gifts when they were mailed or delivered to the recipients. The Tax Court found that under local state law, the remaining checks were part of the estate because the checks were not completed gifts apply to the taxpayers death.

Example

- The Tax Court noted that the mere delivery of a check does not complete a gift. A gift is not completed until the donor has parted with dominion and control over the check. This happens with the account on which the check is drawn accepts certifies or makes the final payment of the checks. The checks were not completed lifetime gifts according to the Tax Court. The state appealed to the Third Circuit Court of Appeals which agreed with the Tax Court stating that the remaining checks at issue were all deposited and paid after the taxpayer's death there was no actual or constructive delivery sufficient to divest the taxpayer of dominion so the checks were still revocable when the taxpayer died. The checks were not distributed in contemplation of death no evidence to support that allegation.

C. Life Insurance Valuation Issues

- 1. Proceeds from Life insurance policy used to fund redemption of deceased owner shares in a private company or includable for purposes of determining estate tax value without a reduction for the redemption obligation.

Example

- **Connelly v. US,NO. 23 – 146 (US 6/6/24).** The US Supreme Court affirmed and 8 Circuit Ct. decision involving a company's obligation to redeem a deceased shareholders shares of stock in a corporation. Two brothers jointly owned a building supply company and had entered into an agreement that upon either brothers death the corporation would be required to redeem the deceased brother's share under certain situations. To ensure the corporation have enough money for the redemption, the corporation tainted $3.5 million life insurance policy on each brother. Brother Michael died first corporation received life insurance proceeds. On the estate tax return filed for brother Michael, the value the proceeds of the life insurance were all set by the corresponding redemption obligation reducing the estate tax value of his shares in the Corporation.

Example

- The Eighth Circuit held that the proceeds from the life insurance policy used to fund the redemption should be included for purposes of the estate tax value without a reduction for the redemption obligation. Supreme Court affirmed the 8 Circuit Ct.'s decision stating that the corporation's contractual obligation redeem shares did not offset the value of the life insurance proceeds committed to funding the redemption. The court stated that the state would not have sold to a hypothetical nonfamily buyer for the amount reported on the estate tax return. The company's requirement to purchase the shares had no effect on the shareholders economic interest.

D. Buy – Sell Agreement and Valuation Issues

- 1. Section 2703 describes certain rights and restrictions that are disregarded when valuing property. Section 2703(a)(1) provides that the value of any property must be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right).

- 2. Section 2703(a)(2) includes any restriction on the right to sell or use such property. Section 2703(b) provides an exception for any option, agreement, right, or restriction if:
  - it is a bona fide business arrangement;
  - it is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and
  - its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction.

Example

- **Huffman v. Comm., TC Memo 2024 – 12**. The Tax Court considered whether a buy-sell agreement to purchase shares in a family-owned aerospace company between a son and his parents' trust and his mother's S corporation should be taken into account in determining the value of the company shares the son bought. The court determined that the agreement's terms were not comparable to similar arrangements entered into by persons in arm's-length transactions. Thus, the agreement did not meet the third requirement of Section 2703(b), and it was disregarded in determining the value of the shares in the company. Disregarding the agreement, the court determined that the value of the shares was much higher than the amount the son paid for them and that the difference between their value and the amount paid was a deemed gift from his parents subject to gift tax.

E. The Revocable Trust and an Split Dollar Insurance Arrangement

- 1. Section 2038- Revocable Transfers

- a. The value the gross estate shall value of all property to the extent of any interest of which the decedent has at any time of transfer, by trust or otherwise, where the enjoyment was subject at the date of death to the chain exercise of a power by the decedent alone or by the decedent in conjunction with others to alter, amend, revoke or terminate or were such powers relinquished during the three-year timeframe ending on the date of the decedent’s death.

Examples

- **Estate of Levine v. Comm., 158 TC 2.** To provide for her grandchildren, before she died Marion Levine created an estate plan that would shelter some of her estate from estate tax. This plan included a revocable grantor trust and an irrevocable insurance trust that purchased split-dollar life insurance on the lives of her daughter and son-in-law with money borrowed from Levine. The insurance trust gave Levine a receivable for the cash.

- What was the value of the split-dollar receivable in Levine's estate on the alternative valuation date? Was it the value of the grantor trust's right to be repaid in the future or the cash-surrender value of the life-insurance policies on the alternate valuation date?

Examples

- The Tax Court held that only the value of the split-dollar receivable Levine was holding at the time of her death was includible in her estate and the estate correctly calculated that value. The court found that the life insurance policies weren't included in Levine's estate because they were always owned by the insurance trust. The insurance trust bought the policies and held them. Therefore, the insurance policies weren't includible in Levine's estate. Levine gave money to the insurance trust in exchange for the split-dollar receivable. Thus, the receivable wasn't transferred property but property retained by Levine and, after Levine's death, belonged to her estate.

Examples

- Levine did voluntarily transfer the $6.5 million to the insurance trust. But Levine didn't retain an interest in that cash. Instead, she received the split-dollar receivable, which gave her the right to the greater of $6.5 million or the cash-surrender value of the policies. Levine didn't have any immediate contractual right to the policies cash-surrender value, she had to wait until her daughter or son-in-law died (theirs were the lives insured) or the policies were terminated and only the insurance trust had the right to terminate the policies.

Examples

- The Tax Court rejected the IRS's argument that Levine could have unwound the split-dollar transaction at will because her attorneys-in-fact stood on both sides of the transaction. The Court found Levine's attorneys-in-fact, who were also the trustees of her grantor trust, stood in her shoes for this split-dollar arrangement. However, the attorneys-in-fact weren't on both sides of the transaction. The insurance trust owned the life-insurance policies, and it had a separate unrelated trustee. The one attorney-in-fact (Larson) who had a role in the insurance trust could only direct its investments. Moreover, the insurance trust was irrevocable, so neither Levine nor her attorneys-in-fact had any right to change, modify, amend or revoke its terms.

Examples

- Since Larson, in his role as an attorney-in-fact, could not take any action which Levine could not take herself, he could not surrender the policies in his capacity as attorney-in-fact because Levine did not retain any right to possession or enjoyment of the cash she transferred. Larson, in his role as the single member of the insurance trust's investment committee, was acting in a fiduciary capacity and Levine's children (the other attorneys-in-fact) were not the only beneficiaries of the insurance trust; so were Levine's grandchildren. According to the insurance trust's terms, Levine's grandchildren wouldn't receive anything if the life-insurance policies were surrendered while Levine's children were living. Thus, if Larson surrendered the policies before Levine's children died he would breach his fiduciary duties to those beneficiaries.

Examples

- The court determined that the property to be valued for estate tax purposes was the split-dollar receivable. This was included in Levine's estate because she held the receivable at the time of her death and there were no restrictions on what she could do with that property. The IRS and the estate agreed on the value of the split-dollar receivable.

F. Transfers with Retained Life Estate – Section 2036

- 1. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death:
  - the possession or enjoyment of, or the right to the income from, the property, or
  - the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Example

- **Milner Fields v. Comm., TC Memo 2024 – 90**. Section 2036 (a) required inclusion in gross estate of value of underlying assets exceeding value of partnership interest to which decedent's great-nephew/POA transferred assets on decedent's behalf shortly before her death. Notably, until her death, decedent retained enjoyment of transferred assets, right to income from same, and right to designate who should possess or enjoy that income. And estate failed to prove that transfers were bona fide. Although estate put forth number of plausible non-tax reasons for transfers, including allegedly to avoid elder abuse, to allow for appointment of successor manager, to resolve issues with banks not honoring POA, and to allow for consolidated asset management, those claims ultimately weren't credible when considering surrounding circumstances and timeline of transfers; instead, it appeared transfers weren't for any reason other than reducing estate tax.

VI. Estate Deductions

A. Charitable Deduction – Section 2055

- 1. Charitable Deduction for an estate will be denied in association with the trust where the trust does not qualify as a charitable remainder annuity trust. In creating a charitable remainder annuity trust, the trust must possess either a specified dollar amount for a fixed percentage. This did not occur in there was no reformation of the trust to make and qualified. (See Estate of Block, TC Memo., 2023 – 30)

- **2. CCA 202233014**. The service has indicated that a decedent's estate was not entitled to an estate tax deduction for a portion of the unitrust interest that could be distributed either to a charity or the decedent's spouse at the discretion of the trustee. Section 2055 (a) allows an estate a taxable charter reduction transfers to a charity. The code section does allow a deduction for the interest is a partial interest in interest in the same property passes to a non-charity. However, no deduction will be allowed unless the interest is in the form of a guaranteed annuity or unitrust interest. The unitrust portion or unitrust interest did not qualify for channel reduction it was not in the form of a fixed amount or an amount that was ascertainable nor severable from the non-charitable interest.

B. Claims Against the Estate – Section 2053

- 1. Payments a decedent makes to relatives where the payments are required also to be made under a prenuptial agreement are not deductible claims against the estate.

Example

- **Estate of Spizzirri, TC Memo., 2023-25**. The decedent had been married 4 times. He had 4 children from his first marriage and 3 stepchildren from his last marriage. Before the last marriage he entered into a prenuptial agreement. Among the provisions was a provision in his will which would include payments to the surviving spouse and a one million-dollar gift to each of the stepchildren. The last wife filed a claim in the probate seeking enforcement of the prenuptial agreement. The surviving spouse's children also filed a claim. The estate paid the bequests and sent 1099s. The estate subsequently filed an estate tax return and reported no adjusted taxable gifts even though the payments were made and exceeded the gift tax exclusion. The return also reported payments the surviving spouse children as claims against the estate reducing the taxable estate. The IRS disagreed and assessed additional taxes they disallowed the claims against the estate.

Example

- The Tax Court determined that the state failed to meet its burden of the transfers were not gifts. The state are the transfers payments for care and companionship during the decedent's life. The court noted decedent make transfers by check and there was no indication that they were meant as compensation. In addition, the decedent failed to issue any 1099s related to the payments nor report them on his personal return. Witnesses failed to establish the transfers or anything other than a gift. The court determined that there was amounts were of a donative nature and not an agreement associated with services.

B. Claims Against the Estate – Section 2053

- 2. Claims Against the Estate must arise out of the Decedent's personal obligations existing at the time of Death.

Example

- **MacElhenny v. Comm., TC Memo 2023 – 33**. The Tax Court held that an estate could not deduct the value of two consent judgments against the decedent which arose in a commercial lending arrangement because the debts were satisfied before the decedent died and therefore were not the decedent's personal obligations at the time of his death as required by Section 2053. The court also held that the decedent's children received taxable gifts by purchasing property from the estate at a discount.

VII. Estate Liability

A. General Rule

- 1. Section 6324 (a) (2) imposes personal liability for unpaid estate taxes on the category of persons listed in the statute. This is generally the recipients of nonprobate property overseas property included in the gross estate or have possession of such property on the date of the decedent’s death.

- 2. Under this code section the service has taken the position that decedent successor executors and trustees and beneficiaries fall within the category of listed persons under Section 6324.

A. General Rule

- 3. The Ninth Circuit in Paulson (68F4th 528, 9th Cir. 2023) held that Sec. 6324(a)(2) imposes personal liability for unpaid estate taxes on the categories of persons listed in the statute (generally, recipients of nonprobate property) who receive property included in the gross estate or have possession of such property on the date of death. The court also held that the defendant successor trustees and trust beneficiaries in the case were within the categories of persons listed in Sec. 6324(a) and were personally liable for unpaid estate taxes, a holding that extended transferee liability further than in prior cases.

- 4. Prior to this decision, courts historically had concluded that the statute applied only to persons in actual possession of assets on the date of death or those with an immediate right to such assets (for example, the beneficiary of a life insurance policy), and not those who took possession at some time in the future. This interpretation was rejected by the Ninth Circuit, and although the decision was appealed to the U.S. Supreme Court, certiorari was denied.

VIII. Gift Tax Update

VIII. Gift Tax Update

- **1. Exclusions**
- a. For 2024, the gift tax exclusion will be $18,000. (See Rev. Proc. 2023 – 34)
- b. For gifts made in 2024, exclusion for gifts to non-citizen spouses will be $185,000. (See Rev. Proc. 2023 – 34)
- c. a. For 2025, the gift tax exclusion will be $19,000. (See Rev. Proc. 2024 – 40)
- b. For gifts made in 2025, exclusion for gifts to non-citizen spouses will be $190,000. (See Rev. Proc. 2024 – 40)

VIII. Gift Tax Update

- **2. Foreign Gift Reporting – Section 6039 F**

- a. If the value of the aggregate foreign gifts received by a U.S. person exceeds a threshold amount, the U.S. person must report each foreign gift to IRS. The reporting thresholds apply for gifts received from nonresident alien individuals or foreign estates, and foreign partnerships or foreign corporations.

- b. For gifts from a nonresident alien individual or foreign estate, reporting is required only if the aggregate amount of gifts from that person exceeds $100,000 during the tax year.

- c. For gifts from foreign corporations and foreign partnerships made in 2024, the reporting threshold amount will be $19,570. (See Rev. Proc. 2023 – 38)

IX. Trust Update

A. Grantor Trust Issues

- **1. CCA 202352018**. The IRS concluded that modifying a grantor trust to add a tax reimbursement clause constituted a taxable gift by the consenting trust beneficiaries to the grantor, because the addition of a discretionary power to distribute income and principal to the grantor was a relinquishment of a portion of the beneficiaries' interest in the trust. This new position contradicts a previous IRS letter ruling from 2016 that allowed such modifications without triggering gift tax.23 The IRS acknowledged this inconsistency and clarified in the CCA that the letter ruling no longer reflects its official position. The CCA offers limited guidance on valuing the deemed gift, suggesting that the value could be equal to the entire value of the trust.

B. Q-tip Trust Termination

- 1. The Termination of a qualified terminal interest property trust by the surviving spouse and distribution of assets to the surviving spouse does not trigger a gift tax liability under Section 2501.

Example

- **Estate of Annenberg v. Comm.,162 TC No. 9.** The Tax Court held that even if the transfer was property under Section 2519 the estate is not liable for the gift tax because the surviving spouse received back the interest in the property that she was treated as holding and transferring and made no gratuitous transfer under Section 2501. The service in a prior CCA 202118008 advise the termination of a Q-tip trust were assets were distributed surviving spouse would result in a state exclusion and separate gift transfers. The service in this court case focused on whether the surviving spouse had made a gift and did not address whether any remaining or remainder beneficiaries consented to the termination that would constitute a gift. The court said so long as there is no evidence of a gratuitous transfer no gift tax can occur.

X. Greenbook Update Estate and Gift Tax Provisions

A. Introduction

- 1. The Greenbook is issued annually by Treasury and is designed to provide a detailed account of the current administration's revenue proposals and legislative initiatives.

- 2. The current green but has the following proposals included:

A. Introduction

– Impose a 25% minimum income tax on taxpayers with greater than $100 million in wealth;
– Require reporting of estimated total value of trust assets and other information about the trust, including the inclusion ratio in certain circumstances;
– Require that a defined value formula clause be based on a variable that does not require IRS involvement;
– Cap the gift tax annual exclusion at $50,000 per donor, indexed for inflation after 2025, and remove the present-interest requirement;
– Modify tax rules for grantor retained annuity trusts to require the remainder interest to have a minimum value for gift tax purposes equal to the greater of 25% of the value of the assets transferred or $500,000, but not more than the value of the assets transferred;
– Treat transactions between grantors and their grantor trust as regarded for income tax purposes;
– Provide that the payment of income tax on the income of a grantor trust is a gift;
– Redetermine a trust's GST inclusion ratio on certain transactions, including decanting and sales between a GST-nonexempt and a GST-exempt trust;
– Treat loans made by a trust to a trust beneficiary as a distribution for income tax purposes;
– Revise rules for valuation of promissory notes and fractional interests; and
– Revise the definition of a "guaranteed annuity" from a charitable lead annuity trust to require that the value of the remainder interest be at least 10% of the value of the property transferred.

SECTION IX:

SCHEDULE C AND F ISSUES

I. SOLE PROPRIETORSHIPS

A. Hobby Losses – Schedule C and F Issues General Rules

- 1. With respect to Section 183 the general rule is outlined in Section 183(a), which states the following:

- "In the case of any activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section."

- 2. Section 183(c) states that the definition of an "Activity Not Engaged in For Profit"

- "Means any activity other than one with respect to which deductions are allowable under Section 162 or under paragraph (1) or (2) of section 212."

A. Hobby Losses – Schedule C and F Issues General Rules

- 3. Section 183(e) states the following pertaining to postponement of a presumption of non-profit. Specifically, the language indicates the following:

- "A determination as to whether the presumption provided by subsection (d) applies with respect to any activity shall, if the taxpayer so elects, not be made before the close of the fourth taxable year... following the taxable year in which the taxpayer first engages in the activity."

- 4. Reg. Section 1.183-2(b) states that all facts and circumstances that bear on the activity are to be taken into account in determining whether the activity was engaged in for profit. Included are the following factors:

A. Hobby Losses – Schedule C and F Issues General Rules

- a. The manner in which the taxpayer carried on the activity;
- b. The expertise of the taxpayer or her advisers;
- c. The time and effort spent by the taxpayer in carrying on the activity;
- d. The expectation that the assets used in the activity may appreciate in value;
- e. The success of the taxpayer in carrying on other similar or dissimilar activities;
- f. The taxpayer's history of income or losses with respect to the activity;
- g. The amount of occasional profits, if any, which are earned;
- h. The financial status of the taxpayer;
- i. The presence of elements of personal pleasure or recreation;
- j. No single factor is controlling in the determination. (See Barnes v. Commissioner, TC Memo 1992-72 (1992); Dunn v. Comone bad head missioner 70 TC 715 (1978) affd. 615 F. 2d 578 (2nd Cir, 1980))

A. Hobby Losses – Schedule C and F Issues General Rules

- 5. The IRS released an updated audit guide relating to hobby losses: Publication 5558 IRS Audit Technique Guide: Activities Not Engaged in for Profit — Internal Revenue Code Section 183.

B. IRS Publication 5558

- 1. As previously indicated, the IRS has updated its audit guidelines with respect to hobby loss issues. Much of the publication focuses on the factors that must be examined to ascertain whether or not it activity is one that is engaged in for profit. The factors have a narrower interpretation by the service as indicated herein.

- 2. One of the considerations before applying the factors is that an audit by the IRS agent is required to ascertain if there is a profit motive. The determination of a profit motive is a facts and circumstance examination. The emphasis is on Section 162 or expenses ordinary and necessary with relation to the activity and more importantly are those expenses that are ordinary and necessary made in the furtherance of a bona fide profit motive activity. (Green v. Comm., 507 F3d 857, 871 (5th Cir., 2007)

- 3. In addition, an examination will ascertain whether the activity falls within the confines of a trade or business. Trade or business under Section 162 refers to an activity conducted with continuity and regularity with the primary purpose of earning income or making a profit. (Comm., v. Groetzinger, 480 US 23, 35 (1987)).

B. IRS Publication 5558

- 4. The audit guideline further indicates that expenses are ordinary and necessary if the expense or expenditures are appropriate, helpful and common are frequent in nature in association with the type of business the taxpayer is engaged in. (Tulia Feedlot, Inc. v. US, 513 F2d 800, 804 – 05 (5th Cir., 1975)

- 5. Section 183 (e) (1) allows a taxpayer to elect to postpone a determination as to whether an activity is or is not engaged in profit until the close of the fourth tax year following the tax year the taxpayer first engaged in the activity. For purposes of agriculture and specifically breeding, training, showing or raising of horses, the postponement is the sixth year or six years following the tax year in which the taxpayer first engaged in the activity.

- 6. Section 183 (e) (2) if the taxpayer makes such an election the presumption shall apply to each taxable year in the fifth or seventh year period beginning with the tax year in which the taxpayer first engages in the activity, if the gross income derived from the activity for 3 (or 2 if applicable) or more the taxable years in such period exceeds the deductions attributable to the activity.

B. IRS Publication 5558

- **7. The election for postponement is on Form 5213**: Election to Postpone Determination as to whether the Presumption Applies and Activity is Engaged in for Profit. For the election to be timely, the taxpayer must file form than three years after the due date of the return without regards to extensions, for the first taxable year it was a taxpayer was engaged in the activity. Likewise, if the taxpayer receives a statutory notice of deficiency from the IRS proposing to disallow deductions attributable to an activity not engaged in for-profit taxpayer must file the form no later than 60 days after the taxpayer received the notice.

- 8. The Publication does discuss the factors associated with determining whether an activity is or is not engaged in a profit making activity. The publication goes to some great detail on these factors.

B. IRS Publication 5558

- **9. The Manner in which the Taxpayer Carries On the Activity**. Under this factor, the service will try attempt to ascertain whether the taxpayer conducts the activity in a businesslike manner. This includes maintaining complete and accurate books and records, making changes to operational methods to improve profitability and whether activities were carried out efficiently systematically and the way not to waste time or being distracted by personal or other concerns. Interestingly enough, the publications cites the small business administration in ascertaining business like activity. An activity would be considered appropriate as a trade or business it would be operating successfully if evidence showed the taxpayer had a viable idea, business plan, funding, legal structure, name, tax ID number, license, permit and a business bank account.

B. IRS Publication 5558

- **10. Expertise of the Taxpayer or Advisors**. Under this factor the agents will attempt to ascertain whether the taxpayer has sought experts and whether or not they have followed the experts advice. In addition, the agents will inquire as to what the taxpayer did to prepare for operating the activity. This includes formal, informal or degree of related fields of study in relation to the business. Informal activity can include attending seminars and trade meetings, studying at home, buying books or other learning aids in the process of developing expertise on the business as well as economic practices associated with the activity.

B. IRS Publication 5558

- **11. Timely Effort Expended by the Taxpayer in Carrying on the Activity**. Often this activity while focusing on time is also associated to a degree with the financial status of the taxpayer and elements of personal pleasure. Under the publication, the IRS notes that time and effort spent the taxpayer in operating the activity does not need to be exclusive or significant if competent management or employees are hired to operate the activity. However, it is important for the taxpayer to account for how they spend all their time and not just the time spend on operating the activity. This includes all business, investment, employment (e.g., W-2 employee), and personal activities.

B. IRS Publication 5558

- **12. Expectation the Assets Used in the Activity May Appreciate in Value**. Under this factor, the service has to determine if the taxpayer are relying on an asset to appreciate and overcome the losses. Often this is a challenge regarding land. With respect to land that is purchased with the intent to profit from its appreciation and the taxpayer also farms on the land, the farming and the holding of the land will generally be considered to be a single activity. In essence, farming and holding of the land will be considered a single activity if the income from farming exceeds the farming expenses that are not directly attributable to the holding of the land. Deductions other than those directly attributable to the holding of the land include interest on a mortgage secured by the land, property taxes attributable to the land, improvements to the land, and depreciation of improvements to the land. (See Treas. Reg. 1.183-1(d)) Despite the farming of land, the agent on audit is required to ascertain if the taxpayer is relying on the land to appreciate and overcome the losses. If there are several parcels of land, the taxpayer should be asked to specify which parcel the taxpayer may be relying on- all the land or some of the land. This needs to be established because as in the case of farming activities, farms usually include acreage for farming as well as a parcel of land upon which the personal residence sits on.

B. IRS Publication 5558

- The examiner should also ask the taxpayer for his/her motivations for purchasing the land. This is critical because if a taxpayer fails to consider the possibility of asset appreciation before purchasing the requisite assets for a given activity, this may tend to indicate that the taxpayer was not expecting an increase in the value of the acquired assets. (See Scull v. Comm., T.C. Memo 1983-33.) Examiners should ask the taxpayer to provide supporting documents on the potential for appreciation of land by reviewing appraisals or comparables for properties like the taxpayer's property. Treas. Reg. 1.183-1(d) provides that where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, farming and the holding of the land will ordinarily be considered a single activity but only if the farming activity reduces the net cost of carrying the land for its appreciation in value.

B. IRS Publication 5558

- **13. Success of the Taxpayer in Carrying on Other Similar or Dissimilar Activities**. This information can be gathered from the tax returns the publication requires the examiner's to prepare a worksheet that details the history of other activities and show the profits and losses derived from those activities. Examiners should focus on activities other than the taxpayer's primary source of income. For example, if the taxpayer is a medical doctor, examiners should not focus on their success with their medical practice. Instead, examiners should focus on the taxpayer's success or failure in other unrelated ventures such as the operation of a restaurant or a kennel. Inquiry should be also be made regarding abandonment or a bankruptcy filing.

- **14. Taxpayer's History of Income or Losses with Respect to the Activity**. The publications suggest the agents prepare a comparative analysis of income, expenses profit or loss during the pre-examination stage. The publication states the comparative analysis should include since the inception of the activity. The agents can utilize the Integrated Data Retrieval System for prior tax years.

B. IRS Publication 5558

- **15. Amount of Occasional Profit that Is Earned.** Strangely enough the focus here is on gross receipts, not on profit. The examiners are to ascertain the source of gross receipts and whether there was an error in reporting those gross receipts.

- **16. Financial Status of the Taxpayer**. The agents here are required to perform a tax savings benefit analysis with the first year the activity being included and ascertaining whether the activity that is the subject of the audit is financed by the taxpayer or by third-party such as a bank.

- **17. Elements of Personal Pleasure or Recreation**. The focus here is whether the taxpayer engaged in the activity with a profit motive. The agents have to ascertain whether the taxpayer or their family use of the activity as well the assumption in that scenario would be personal or recreational in nature. This factor is often associated with the time and manner in which the activities being conducted.

C. Examples

- **Mazotti v. Comm., TC Memo 2024 – 75**. Married taxpayers/school teacher-wife and husband weren't entitled to business deductions for wife's alleged writing-researching activities that weren't engaged in for profit within meaning of Section 183. Notably, wife admittedly lacked business plan, had no profit-loss statement, didn't otherwise keep adequate records, and overall failed to conduct activities in businesslike manner. Further, although claiming to have consulted experts/famous authors, she didn't offer any credible evidence that any author or other expert provided advice about her activities. She also didn't provide credible evidence of how much time she spent on activity or that she had business success in similar activities; had prolonged period of losses from activities; used said losses to offset other income; and derived personal pleasure from activities or used same for recreational purposes, including by treating extensive family vacations as research trips.

C. Examples

- Schwarz v. Comm., T.C. Memo. 2024-55. The taxpayer was a dentist an oral surgeon. He and his wife had a history of conducting real estate activities in South Texas mostly involving ranchland. The couple bought 15,070 acres of land in Zapata County with the intent to improve and sell it. They later decided to conduct ecotourism operations consisting of hunting, fishing, and events on a portion of the land. In the years at issue, 2015-17, a partnership owned by the Schwarzes named TI conducted ecotourism activity on a portion of the Zapata County land. TI also conducted farming and construction operations on the Zapata County land and other properties owned by the Schwarzes, related entities, and third parties. I filed Schedule F, Profit or Loss From Farming, with its return for each year 2005-20. TI reported income and expenses for both ecotourism and farming/construction operations on Schedule F. TI reported Schedule F gross income totaling over $14 million for years 2005 - 20. Large expenses resulted in TI's reporting a Schedule F net loss for each year. These net losses total over $15 million for years 2005-20. TI's Schedule F losses flowed through to the Schwarzes, who used them to offset significant taxable income. The IRS issued the Schwarzes a notice of deficiency for years 2015-17.

C. Examples

- The IRS determined that TI's Schedule F activity was not engaged in for profit under Code Sec. 183. Multiple adjustments flowed from this determination, including the disallowance of deductions for TI's Schedule F losses. The IRS also determined that a 20 percent accuracy-related penalty applied for each year at issue. The taxpayers filed a Tax Court petition challenging the IRS's determinations. They contended that TI's Schedule F activity was engaged in for profit and that it and the real estate activities that the Schwarzes and related entities conducted were a single activity. They also contended they had a reasonable cause defense to penalties due to their good faith reliance on Russell Guthrie, an experienced CPA who prepared their returns for the years at issue. he Tax Court held that TI''s Schedule F activity and the taxpayers' real estate activities were separate activities the farming activity was not engaged in for profit in the years at issue, and the taxpayers were not liable for accuracy-related penalties.

C. Examples

- The court found that the Schwarzes' characterization of their farming and real estate activities as one activity was artificial and unreasonable. The court reasoned that the Schwarzes are intelligent people who knew for certain that they will never profit from TI's ecotourism or TI's farming activity as a whole. They thus sought to tie the farming activity to the profitable real estate activities. But the court found that these ties were weak, and the Schwarzes' position was contrary to the language and intent of Reg. Sec. 1.183-1(d)(1). The court noted that the Schwarzes chose to structure entities they partially or wholly owned in such a way that TI's Schedule F activity was separate from the real estate activities. The court further found that TI's Schedule F expenses as a whole did not substantially relate to the real estate activities, and that the Schedule F and real estate activities had distinct objectives.

C. Examples

- The court further held that TI's farming activity was not engaged in with the intent to make a profit after finding that most of the factors set forth in Reg. Sec. 1.183-2(b) favored the IRS. Of these, the court believed that the factors pertaining to TI's history of losses and lack of profits were the most significant. The court found that year after year, TI's farming activity continued to lose money, and there was no indication it would ever be profitable. The court believed that Dr. Schwarz was following his longtime passion for deer and ranch development and pursued this independently of any desire to earn a profit. The court observed that the Schwarzes had money to do this, especially when they knew that the real estate market was strong. Considering all the facts and circumstances, the court concluded that the Schwarzes did not have an actual and honest profit objective.

C. Examples

- **Kraske v. Comm., TC Memo 2023-128**. Taxpayer working over 50 hours per week as a cloud computing engineer consultant was not engaged in activity for profit. The activity was not operating a businesslike manner as shown by facts that taxpayer didn't keep separate business records, that he didn't adjust system or methods to improve profitability, and that only ostensible business plan was comprised largely of buzzwords and general aspirations but didn't include budgets or provide roadmap for completing projects. Also, other factors indicating not-for-profit nature of activity included that taxpayer didn't show how much time he spent on activity; admitted that expert allegedly hired as part of activity was personal friend with whom taxpayer spent time attending movies and other entertainment events; didn't show expectation that activity assets/computer servers and networking components would appreciate in value; used activity losses to offset other income; and appeared to derive personal pleasure from activity.

C. Examples

- Swanson v. Comm., TC Memo 2023 – 81. Taxpayer’s fish charter activity business was not considered a for-profit business under Section 183. Taxpayer did not maintain complete records or separate bank accounts for the activity, had no business plan and failed to adjust operating methods despite numerous years of losses which demonstrate he did not conduct the activity in a businesslike manner. While taxpayer obtain fishing license and commercial insurance and began using applications to track his business income and engage in advertising, some of these changes had nothing to do with profitability and were instead regulatory in nature. Despite taxpayer’s lack of clients and income he purchased airplane and incurred certificate expenses related to storing and operating of the planes. Taxpayer lacked expertise in running fishing charter business and did not consult with advisors. Taxpayer spent little time the activity. He made numerous rental properties also generate losses. His fishing activities were also of a personal nature.

C. Examples

- Gregory v. Comm., (CA 11), 131 AFTR2d 2023 – 700. The 11th Circuit Court of Appeals denied the taxpayer's petition for review of the Tax Court decision that denied deductions for their boat chartering activities. The deductions were capped at the income of the activity. Taxpayer argued that the excess deductions denied on Schedule C should be carried over as a miscellaneous deduction on Schedule A.

- Sherman v. Comm., TC Memo 2023 – 63. Taxpayer was the physician who also had a long time activity as a musician. He was involved in musical film production activity and he failed to meet the for-profit rules of Section 183 The taxpayer lacked business plan, did not show when activity began or if it was licensed, and did not keep accurate books and records showed he did not conduct activity in businesslike manner. The taxpayer did not consult with experts in field; offered no proof to support his estimate of spending hundreds of hours on activity, while he was also claiming to have worked significant hours as physician; failed to prove any expectation of appreciation in value of activity assets; reported significant losses on activity; and used same to offset income from his job as a physician.

C. Examples

- Skolnick, et al., v. Comm., CA3 131 AFTR2d 2023-470. The Third circuit court of appeals affirmed the tax court's decision denying the net operating loss deductions and the declaration that the farming activity was a hobby under Section 183. During 2010-2013 petitioners Mitchel Skolnick and Eric Freeman were co-owners of Bluestone Farms, a horse breeding farm in New Jersey. Bluestone breeds Standardbred horses, a breed used in competitive harness racing. Bluestone is treated as a partnership for Federal income tax purposes and file s returns on Form 1065, U.S. Return of Partnership Income. Bluestone's stated mission was to acquire land and establish a Standardbred breeding farm that would sell high- quality yearlings at respected public auctions. At the outset of their venture Mitchel and Eric drafted a business plan and a budget. They planned to buy a stallion, raise revenue by breeding the stallion and boarding other owners' horses for a fee, and then buy additional horses. If everything went according to plan, they projected that Bluestone would make a small profit during each of its first three years.

C. Examples

- The partnership had 7 to 10 employees both full and part-time since inception partnership had losses in the losses grew over time from $109,000 in 1998 to over $1.1 million in 2009. During 2010-2013 Bluestone had three main sources of potential income: horse sales (selling yearlings and any horses that were culled), income from racing the horses (in the form of purses or breeder's awards), and stud fees (selling the rights to breed with a stallion). From 2014 through 2017 ordinary losses continue to arrange on average of over $800,000. In 2014 the IRS selected the taxpayers individual return for a routine examination and that grew into the examination of the partnership. The losses from the partnership were carried forward and passed through to the individuals returns each year. The partnership which was an LLC filing as a partnership was audited during the same time. The partnership was found to be a hobby by the IRS. The service also argued lack of material participation in the alternative but did not state such in their notice of deficiency. The court indicated that since the IRS cannot raised it in writing they could not raise the lack of material participation as an alternative argument. The Court did reference Section 162 ordinary and necessary business expenses in ascertaining whether the activity was a for-profit activity. The Court did address the 9 factors under Section 183.

C. Examples

- 1. Record Keeping. The court noted that the records of the LLC were voluminous. He also noted that the business advertised services, maintained a website and hired a CPA to prepare books and tax returns. Business also had 72 10 full-time employees and part-time employees. However, the records contain numerous accuracies and gaps particularly as they related to monetary expenditures. There was no documentation in the records regarding partner's contributions into the partnership in terms of their purpose and subsequent repayment. There was also no documentation on changes of ownership that occurred over time. Capital was not contributed proportionately among the partners. The LLCs conduct of its activities showed incredible insensitivity to cost. Specifically, they never had a budget, no financial statements or financial forecast or break even analysis was prepared. The records were not used in a fashion to improve profitability and implement techniques to control expenses and increase income which is critical in meeting that element. What is noteworthy is that employees had suggested cost cutting measures which were not implemented by the LLC management. One specific issue was that the taxpayers did not view the horse activity in terms of income and expenses and they stayed.

C. Examples

- 2. Personal and Business Pleasure. The partners resided on the farm throughout the years at issue. There was little distinction in expenditures between business and personal. One of the partners also resided on the premises rent-free. Also, other partners had their horses transported on the property at the LLCs expense. These horses were not part of the breeding operations but were personal in nature.

- 3. Expertise of the taxpayer or their Advisors. The taxpayers had prior experience in investing in horses. The taxpayers did consult with leading experts in the horse industry both from a profit perspective and cost-cutting perspective. This was viewed in favor of the taxpayer.

C. Examples

- 3. Taxpayers Time and Effort. Sec. 1.183 -2(b)(3), Income Tax Regs. Intention to derive a profit may also be supported by the taxpayer's "withdrawal from another occupation to devote most of his energies to the activity." Even where a tax-payer himself devotes limited time to an activity, a profit motive may be indicated if he "employs competent and qualified persons to carry on such activity." In this particular case, taxpayers employees through him under the bus stating that the taxpayer was not a hands-on manager that his role was limited mostly to office tax. The taxpayer buys missions for 6 months out of state and visited the farm only occasionally during the rest of the year. He was generally limited to watching races, attending social events and did not express any interest in the care of the animals. They avoided tasks of running the farm, maintaining the grounds etc. They did employ 7 to 10 full-time employees all with prior experience in horse racing. Taxpayers were previously involved in IT consulting firm that they withdrew from that when they started this business. This factor was viewed as neutral.

C. Examples

- 4. Expectation of Appreciation in Value. A belief of appreciation in value is not enough to meet the test. Taxpayers indicated the land was a significant value more so than the horses. There was a lack of a formal appraisal. The taxpayers purchase additional land suspension of profit centers over time this was held in their favor. Nonetheless because of the lack of formal appraisals this was viewed as a neutral position.

- 5. Success in Carrying On Similar Activities. The taxpayer's previous career was in software and software development. The other partners previous career with the insurance. There is no evidence that this excess in those prior endeavors work any predictor of success in the horse breeding business. The factor was viewed as neutral.

C. Examples

- 6. History of Income or Losses. There will losses since inception of the LLC and the losses grew over time. This did not favor the taxpayers.
- 7. Amount of Occasional Profits. The court did acknowledge that horse racing and horse breeding is a highly speculative business. There were no profits ever derived since inception. Profit activity focused more on breeding and not on racing as indicated in the business plan. This favored the IRS and not the taxpayer.
- 8. Financial Status of the Taxpayer. Despite the fact that taxpayer had left his IT consulting business and the other taxpayer had left his insurance business, both had inherited monies from their families of over $10 million which were funded in trusts and those funds were often used for the operations of the business. This was viewed as a neutral position.

C. Examples

- 9. Elements of Personal Pleasure. The taxpayers admitted they enjoyed buying selling breeding and racing horses. The evidence indicated that the pleasure derived these activities overwhelmed the desire to make a profit by their own nation. The evidence also indicated that one of the taxpayers was funding operations from a testamentary trust he inherited with no desire to know anything about the feeding, care, maintenance, veterinary care of the animals. This was used in favor of the IRS and not the taxpayers.

- As a result, the activity was rendered to be a hobby and the net operating loss carryforwards were denied.

D. Office in Home – Section 280 A

- 1. The Tax Cuts and Jobs Act suspended the business use of the home for the years 2018 through 2025 for employees. The office in home deduction still applies to self-employed individuals and independent contractors.

- 2. To deduct expenses related to the business use of the home, the taxpayer must demonstrate the
- following:
  - Exclusive Use of the Home
  - Use on a regular basis and,
  - In connection with a trade or business, and either,
    - Used as the principal place of business for any of the taxpayer's trade or business, or
    - As a place of business for meetings or dealing with patients, clients, or customers in the ordinary course of business, or
    - In connection with the taxpayer's trade or business if the taxpayer is using a separate structure that is not to the home dwelling.

D. Office in Home – Section 280 A

- 3. Under Section 280A (c) (1), the home office qualifies as the taxpayer's principal place of business if there is no other fixed location of the trade or business where the taxpayer conducts substantially administrative or managerial activities of the trade or business. Historically, this pertains to salespersons and real estate agents able to deduct their office in their home.

Examples

- **Kalk v. Comm., TC Memo 2024 – 82**. Taxpayer was not entitled to a home office deduction during the years to which you perform consulting services as a subcontractor. The taxpayer failed to prove that the focal point of her business was her home. Notably the bulk of the services she provided was on clients sites. The taxpayer did not establish what portion of her home was also exclusive in nature for business purposes.

- **Tucker v. Comm., TC Memo 2023 – 87**. Taxpayers were not entitled to home office deduction for utility expenses related to wife's fashion lifestyle brand business as taxpayers did not do an allocation between business and personal use which fails as far substantiation of expenses.

Examples

- **Greatest Common Factor v. Comm., TC Memo 2023-39**. Closely held corp. owned by individual who worked as subcontractor for engineering services/defense contracting firm and his spouse, wasn't entitled to home office deduction for years for which its only income was from that defense contracting firm. Notably, corp. offered no evidence that it expended any funds on purported home office. Moreover, even if treating individual owner/subcontractor rather than corp. as taxpayer, deduction would still fail when considering that owner worked at military base and wasn't allowed to take home any work due to classified nature of same.

- **Amundsen v. Comm., TC Memo 2023-26.** Taxpayer who is a /CPA wasn't entitled to home office deduction for expenses relating to his accounting practice: while taxpayer claimed that he used portion of residence for his practice, he didn't provide any evidence to show nature or extent of work performed, whether he regularly met with clients there, or any other information relating to his business use of his residence. Fact that he reported rent expenses for 2 locations other than his home office further showed that his residence wasn't his principal place of business; and he failed to show that rent expenses were related to his accounting practice or were business expenses.

D. Office in Home – Section 280 A

- 4. Rev. Proc. 2013-13. The IRS allows an optional simplified method for home office used to calculate the deductible home office expense. The safe harbor is an alternative to the calculation is substantiation of actual expenses. The safe harbor is annual election and is made by simply using the computation. The limitation is $5 multiplied by a maximum of 300 square feet.

II. Excess Business Loss Limitation

A. Limitations

- 1. The CARES Act temporarily suspended the Section 461(l) limitation on excess business losses for pass-through businesses and sole proprietorships for the 2018, 2019, and 2020 tax years.

- 2. For taxable years beginning in 2023, the threshold amount will be $305,000 ($610,000 for joint returns). (See Rev. Proc 2023-34)
- (See Rev. Proc 2023-34)

- 3. For the tax years beginning in 2025, the threshold amount will be $313,000 ($626,000 joint returns) (See Rev. Proc. 2024 – 40

A. Limitations

- 4. The determination of the excess business loss limitation is made at the taxpayer level aggregating all business activities. Gains or losses attributable to trade or businesses of performing services as an employee are not considered.

- 5. Wages are no longer considered business income, and business capital losses are not taken into account in the calculation, whereas net business capital gains are taken into account.

- 6. Despite the loss limitation, the taxpayer is still required to substantiate an operating loss deduction.

Examples

- **Davison v. Comm., TC Memo 2023 – 139**. The taxpayers claimed NOL carryovers be on IRS allowed amounts relating to the pass-throughs from a number of entities. The IRS did allow some claims to the extent substantiated the taxpayers did not substantiate the amounts above and beyond the IRS approved substantiation. In order to claim NOL deductions including carryovers, the amounts are required to be substantiated by the taxpayer.

- **Kouza v. US., DC MI, 132 AFTR2d 2023 – 5319**. The taxpayer was denied pass-through loss deductions and expenses related to their Passthrough businesses due to the lack of substantiation. Taxpayers argued they met the substantiation test and losses should not be limited or denied because they presented QuickBooks summaries that are evidentiary and meet the substantiation requirement.

- **Amos v. Comm., 133AFTR 2d 2024 – 1267**. The 11th Circuit Court of Appeals agree with the Tax Court that the taxpayer who owns several franchises could not substantiate net operating losses dating back 15 years when there were no original records that were produced except tax returns and carryover worksheets. That is not enough to substantiate a net operating loss deduction or excess business loss deduction.

III. Farm and Ranch Income

A. Farmers and Ranchers – IR 2024 – 248; Notice 2024 – 70, 2024 – 43 IRB

- 1. The IRS has extended the period for farmers and ranchers forced to sell or exchange livestock because of drought conditions to replace their livestock and to defer tax on any gains from forced sales or exchanges (drought-sale replacement period).

- 2. The notice provides a replacement period extension for eligible farmers and ranchers that is four years from the end of their first tax year after the first drought-free year to replace the sold or exchanged livestock. As a result, eligible farmers and ranchers whose drought-sale replacement period was scheduled to expire at the end of 2024 will have until the end of their next tax year to replace the sold or exchanged livestock

IV. Self-Employment Tax Matters

A. General

- 1. For 2024, the first $168,600 of your combined wages, tips, and net earnings is subject to any combination of the Social Security part of self-employment tax, Social Security tax, or railroad retirement (tier 1) tax.

- 2. For 2025, the first $176,100 of your combined wages, tips, and net earnings is subject to any combination of the Social Security part of self-employment tax, Social Security tax, or railroad retirement (tier 1) tax.

B. Exemptions from Self Employment Tax

- 1. There are exemptions or taxpayers being subject to self-employment tax. Often these may be associated with treaties.

Example

- **Bibeau v. Comm., TC 2023 – 66.** Taxpayer was a native American tribe member was held liable for self-employment tax on income in association with his law practice. The taxpayer failed to show he was exempt for the tax under treaties with the tribe. Taxpayer argued he was exempt because the treaty he attempted to demonstrate his exemption will provide the tribe with rights to hunt, fish and gather wild rice or tribal lands protecting his rights from modest tax free living. In other words the treaty reference exemptions from modest tax free living. The problem was he was a lawyer and the treaty did not address legal practice as associate with modest tax free living.

C. Calculating Earned Income for Self-Employed Individuals with Qualified Retirement Plans

- 1. If nonelective 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.

- 2. If the SEI didn't 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

- 3. The SEI's contribution deduction is calculated as follows:
- Contribution deduction = EI x Plan Rate.

- 4. 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))

- 5. 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.

SECTION X:

GENERAL BUSINESS TAX ISSUES

I. Section 179 Expense

A. Maximum Deduction

- **1. 2024**. For 2024, the aggregate cost of any Section 179 property that a taxpayer elects to treat as an expense cannot exceed $1,220,000. The expensing limit will be reduced when more than and under § 179(b)(5)(A), the cost of $3.050,000 of expensing-eligible property is placed in service. (Rev. Proc. 2023-34)

- **2. 2025**. For 2025, the aggregate cost of any Section 179 property that a taxpayer elects to treat as an expense cannot exceed $1,250,000. The expensing limit will be reduced when more than and under § 179(b)(5)(A), the cost of $3.130,000 of expensing-eligible property is placed in service. (Rev. Proc. 2023-34)

A. Maximum Deduction

- 1. The definition of Section 179 property was expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging, including beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility where sleeping accommodations are provided. (Reg. Sec. 1.48 – 1 (h)).

- 2. The definition of qualified real property eligible for Section 179 has been expanded to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:
  - Roofs;
  - Heating, ventilation, and air-conditioning property;
  - Fire protection and alarm systems; and
  - Security Systems.

C. Qualified Improvement Property Definition

- 1. The separate rules for restaurant improvement property, retail property improvement in leasehold improvements have been consolidated into a qualified improvement property category which qualifies for section 179 expensing.

D. Election and Substantiation

- 1. A taxpayer can make an election under Section 179(a) to accelerate depreciation by deducting its cost as an expense for the taxable year in which the property is placed in service.
- 2. The election must specify the items of section 179 property to which the election applies and the portion of the cost of each which is to be taken into account.(See Sec. 179(c)(1)(A)).
- 3. The election must also be made on the taxpayer's first income tax return for the taxable year or
- a timely filed amended return. (See Sec. 179(c)(1)(B); sec. 1.179-5(a), Income Tax Regs.

Examples

- **Ottuso v. Comm., TC Memo 2024 – 91**. Taxpayer, who owned a fireplace installation business took Section 179 expenses for a mower, tractor and buggy that were allegedly used in the business. He took these on a late filed return after the IRS had already prepared and submitted a substitute return. The late filed elections after substitute return to file do not take precedent or supersede the substitute return. The mower in the tractor were viewed is listed property requiring the taxpayer to keep contemporaneous records. The taxpayer failed to show that the use of such equipment was used more than 50% of the time the business.

- **Pak, et ux. Commissioner, T.C. Memo. 2024-86.** Married taxpayers were allowed modified depreciation deductions for build-out of shell structure into “high end” restaurant. While taxpayers failed to substantiate expenditures they made in acquiring property, husband's testimony regarding amounts spent on build-out and return for year restaurant commenced operations, on which taxpayers reported placing into service that year nonresidential real property and 7-year property with stated bases, provided reasonable evidentiary basis upon which to estimate their depreciable basis in such property. Accordingly, taxpayers were entitled to half of amounts claimed on return.

Examples

- **Henry v. Comm., TC Memo 2024 – 79**. Taxpayer, who operated tax bill pay services and other businesses along with spouse/"tax specialist," who offered so-called tax saving strategies, was largely denied business deductions for allegedly business-related costs of air and bus travel, hotels, gas, rental cars, car payments, car ins., car repairs, car wash, automotive association, toll roads, parking, metro and bus fare, personal meals, and meals for "private market receptions." Noting that taxpayer's haphazard record keeping wasn't "helpful" and was otherwise undermined by fact that he was part of wife's tax seminars, Tax Court found that even though he presumably conducted some business in locales where he claimed to have traveled, such wasn't enough to satisfy Section 274 (d) 's strict substantiation rule without proof of business purpose. His claims regarding passenger auto expenses and for meals also failed due to lack of substantiation. And local commuting costs weren't deductible in any event. But he was allowed to deduct cost of hotel rooms that were rented to conduct business seminars and related to client recruitment.

Examples

- **Schnackel v. Comm., TC Memo 2024 – 76.** Engineering-design S corp. owner/husband's and former spouse's depreciation deductions for home furnishings they placed in penthouse condominium which husband purchased ostensibly to help grow corp. business, but which he agreed as part of purchase agreement to use as second home, were denied: there was no evidence of any business use of penthouse. Their claim for depreciation deduction or Section 179 expense for luxury vehicle similarly failed due to lack of evidence of business purpose. While husband offered mileage log, such appeared to have been prepared non-contemporaneously and didn't explain business purpose in any event.

II. Bonus Depreciation

A. General

- 1. The Tax Cuts and Jobs Act extends the deadline for placing into service qualified property eligible for bonus depreciation and AMT relief from December 31, 2019 (December 31, 2020 for certain long-production-period property and aircraft) to December 31, 2026 (December 31, 2027 for certain long-production-period property and aircraft). In essence the Act changes the placed in service requirement to provide that qualified property has to be placed in service by the taxpayer before January 1, 2027 except that aircraft and long production which has to be placed in service by January 1, 2028. These regs were finalized in September of 2019.

- 2. The Act increases bonus depreciation for qualified property from 50% to 100% bonus depreciation and cancels the phasedown of bonus depreciation that was to begin in 2018 with a reduction to 40%.

- 3. The increase to bonus depreciation to 100% pertains to qualified property in the applicable percentages are subject to a revised phasedown schedule that is shown below:

A. General

- 100% for property placed in service after September 27, 2017 and before January 1, 2023;
- 80% for property placed in service during calendar year 2023;
- 60% for property placed in service during calendar year 2024;
- 40% for property placed in service during calendar year 2025;
- 20% for property placed in service during calendar year 2026.

A. General

- **Note:** The language in the statute with respect to place in service means both acquired and placed in service. This is particularly important with respect to the 100% in the first year. In addition, the phasedown also applies to long-term production property and aircraft.

- 4. With respect to specified plants, the 100% bonus depreciation applies as well as the phasedown percentages above. Placed in service under this section applies to planted or grafted after September 27, 2017 and before January 1, 2027.

B. Qualified Improvement Property

- 1. The Tax Cuts and Jobs Act eliminated pre-existing definitions of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property replacing those definitions with a single category known as qualified improvement property.

- 2. Effective for property placed in service in 2018 and later years, the CARES Act did a technical correction and designated qualified improvement property as 15 year cost recovery property for depreciation purposes. Under this provision qualified improvement property means any prudent may be the taxpayer to the interior portion of a building which is nonresidential commercial property. If such improvement is placed in service at the date the building was first placed in service.

Examples

- **Conrad v. Comm., TC Memo 2023 – 100**. Taxpayer was denied depreciation expenses regarding a yacht and airplane because the assets were never in a condition or state of readiness and availability for specifically assigned function. The court did allow deductions for storage, maintenance and upkeep because they were still business assets.

- **Greatest Common Factor v. Comm., TC Memo 2023-39.** Closely held corp., which was owned by individual who worked as subcontractor for engineering services/defense contracting firm and his spouse, wasn't entitled to depreciation deductions for number of vehicles in respect to which there were no supporting documents to show vehicles' purchase prices, ownership, or business purpose

III. Ordinary and Necessary Trade or Business Expenses – Section 162

A. General Rule

- 1. Section 162(a) generally allows a deduction for the ordinary and necessary expenses paid during the taxable year in carrying on a trade or business. Under Section 162 (a), to qualify as an ordinary and necessary business expense the expense must:
  - Be paid or incurred during the tax year,
  - Be for caring on a trade or business,
  - Be an expense,
  - Be ordinary,
  - Be necessary. (Comm. v. Lincoln Savings and Loan Association, 403 US 345, 352 (1971))
- 2. The term “ordinary” means that the expense is normal, usual, or customary in the taxpayer's trade or business. (See Deputy v. du Pont, 308 U.S. 488, 495 (1940)).
- 3. The term “necessary” means the expense is appropriate or helpful in carrying on the trade or business. (See Heineman v. Commissioner, 82 T.C. 538, 543 (1984)).

A. General Rule

- 4. The expenses must proximately relate to the taxpayer's trade or business. (See Larrabee v. Commissioner, 33 T.C. 838, 843 (1960); Treas. Reg. § 1.162-1(a)).

- 5. Cohan Rule. If the taxpayers able to establish that he or she paid or incurred deductible expense but is unable to substantiate the precise amount, the Courts generally may approximate the deductible amount only if the taxpayer present sufficient evidence to establish a rational basis for the estimate. (See Cohan v. Comm., 39F2d 540, 543 – 544 (2nd CIR, 1930))

- a. To qualify under the rule for the estimation treatment, the taxpayer must establish that they were entitled to the deduction.. This rule does not apply to listed property or section 274 substantiation requirements.

- 6. Costs of Goods Sold

Examples

- **Kalk v. Comm., TC Memo 2024 – 82**. Taxpayer was not entitled to cost of goods sold deduction due to the lack of substantiation. The taxpayers testimony regarding the cost of goods sold incurred in the business was not credible as she felt provide evidence to corroborate her testimony. The taxpayer failed to provide any receipts, credit card statements, bank statements or other evidence to support the expenditures. Likewise, taxpayer is not entitled to business deductions including expenses for office deductions, utilities, rent expense, commissions and fees due to lack of substantiation. The court did indicate that the: rule does apply that the taxpayer has to have some sort of corroboration.

- **Alvarado v Comm., TC Memo 2024 – 1**. The Tax Court found that a tax professional who also operate a used car business as a sole proprietor understated gross income but use the Cohan rule to determine cost of goods sold at 55% of sales while the tax return claim 82% in the iris adjustment was based on a 36% rate. The court allowed the rule to prevail based upon the methodology used in determining the estimate and did not apply the strict requirements standard under Section 274.

A. General Rule

- **7. Insurance and Contract Labor**

- Example

- **Thompson v. Comm., TC Memo 2024 – 14**. The taxpayers who had earned income from both farming and a tax preparation business had unreported income from both businesses but more importantly had deductions that they could not prove such as insurance, chicken feed and contract labor. There was not enough information to even apply the Cohan rule for an estimate.

A. General Rule

- **8. Wages**

- Example

- **Frazier v. Comm., TC Memo 2024 – 3.** A C corporation and its shareholders, a married couple, were entitled to salary-and-wage deductions. The Tax Court found that the professional-fee ledger in conjunction with the taxpayers' accountant's testimony established that the C corporation actually paid for the professional-fee expenditures. Further, the Tax Court determined that the C corporation, not the taxpayer-husband, was the other member of another LLC (the LLC).

A. General Rule

- **9. Repairs and Maintenance**
- Example
- **Pangelina v. Comm., TC Memo 2024 – 5**. Taxpayer offered profit and loss statements and bank statements to substantiate rent expense, repairs and maintenance expenses in association with his business. The court did indicate that the: rule can apply here but under that rule the expenses and deductions must identify the payee or provide a business purpose. This was lacking in this case.

A. General Rule

- **10. Legal Fees**

- Example

- **Alvarado v. Comm ., TC Memo 2024 – 1**. Taxpayer hiring an attorney to defend him in a suit brought against his car business, including that brought by the IRS is a valid business expense.

A. General Rule

- **11. Rent Expense**
- Examples
- **Kalk v. Comm., TC Memo 2024 – 82**. Taxpayer was the sole proprietor but was not entitled to storage expense deductions in association with hardware and hardware configurations in relation to her business. The taxpayer provided a sign storage/rental agreement that was signed in her personal name and offered no proof that was used directly in the business.

- **Schnackel v. Comm., TC Memo 2024 – 76.** Rent expense deduction for engineering-design S corp.'s purported rent payments to individual owner, for use of penthouse condominium that owner purchased pursuant to agreement in which he represented that he would occupy penthouse as second home and not rent it out, was denied. While owner claimed that purpose of the penthouse was to cause corp. to be perceived as a successful business in local market and provide lodging for corp. employees who were travelling there for business, he didn't adequately substantiate same in accord where offering only self-serving testimony and credit card statements and calendar that only showed his location and amount of stated transactions, but didn't provide business reason or purpose of his trips or transactions; plus, he didn't offer any evidence as to supposed employees (or clients) using the penthouse. Further, he gave testimony detailing personal use of the penthouse, for family trips and other personal reasons.

A. General Rule

- **12. Advertising Expense**

- Example

- **Henry v. Comm., TC Memo 2024 – 79**. Taxpayer, who operated tax bill pay services and other businesses along with spouse/"tax specialist," who offered so-called tax saving strategies, was allowed some business deductions for advertising and web hosting fees. As to web hosting fees, taxpayer was allowed amounts claimed based on evidence that those amounts were for design and maintenance of websites for the businesses. As to advertising fees, taxpayer was allowed some deduction, to extent "lead sheets" and bank statements listing payments to signage cos. corroborated his claim that he and spouse used signs to attract clientele to their businesses, but deduction was denied for other supposed advertising payments which were made to social media co. or other entities for which business purpose wasn't shown.

A. General Rule

- **13. Bank Service Fees**
- Example
- **Henry v. Comm., TC Memo 2024 – 79**. Taxpayer, who operated tax bill pay service and other businesses with spouse/“tax specialist,” who offered so-called tax saving strategies, was denied business deductions above amounts IRS allowed for merchant banking fees. While IRS allowed some fees, acknowledging that taxpayer used payment processing cos. to conduct his bill pay service and that “no personal expense would incur a merchant bank fee,” additional amounts at issue here didn't contain abbreviations indicating merchant banking fees, and taxpayer didn't offer any other explanation supporting character and deductibility of these amounts. Also, while deductions for bank service fees representing monthly account maintenance costs were allowed, deductions for overdraft, chargeback, and transfer fees were denied as taxpayer, who commingled business and personal income and expenses, failed to show that stated items were for business vs. personal activities.

A. General Rule

- **14. Contract Labor**

- Examples

- **Pak, et ux. Commissioner, T.C. Memo. 2024-86**. Restaurant owner and spouse were entitled to additional contract labor expense deductions above amounts IRS allowed for additional compensation expenses husband incurred in connection with his restaurant. Taxpayers supported amounts claimed (beyond stipulated wage expenses) with husband's testimony that he incurred substantial additional expenses attempting to attract and retain, in competitive hiring market, chefs with skills required for hibachi and sushi operation, and made cash payments to retain such chefs in addition to their wages. Expense amounts were further supported by taxpayers' accountant's testimony that amount of expenses claimed matched amounts listed in husband's bank records and that total labor cost he estimated restaurant paid was within restaurant industry standards for labor costs.

- **Henry v. Comm., TC Memo 2024 – 79**. Taxpayer was denied deductions for contract labor for which taxpayer admitted were casual labor payments. Many of the payments were to his children who are minors and there was no evidence offered that services were rendered.

A. General Rule

- **15. Virtual Office Expenses**

- Example

- **Aulisio, Jr. v. Comm., TC Memo 2024 – 29**. Taxpayer was not entitled to deductions for virtual office expenses allegedly relating to his CPA business. The taxpayer did not provide any valid substantiation at the office expenses were paid in the year issue. The taxpayer offered only other years credit card authorization forms an invoice from a company providing virtual office service. He did provide some bank and credit card statements to support other expenses. However those statements did not show virtual expenses for the year at issue. The court declined to make the Cohan rule estimates on these expenses.

IV. Listed Property

A. Definition – Section 280 F (d) (4);Reg. Sec. 1.280 F – 6 (b))

- 1. The term listed property means any passenger automobiles, which is defined as any for wheeled vehicle manufactured primarily for use on public streets, roads, and highways and rated at 6000 pounds gross vehicle weight or less with the exception of:

- a. An ambulance, curse or combination thereof used for the taxpayer in a trade or business,

- b. A Taxi vehicle used for the taxpayer directly in a trade or business of transporting people or property for compensation or hire, or

- c. A Truck or van that is a qualified nonpersonal use vehicle. (See Reg. Sec. 1.274 – 5 T (k); 1.280 F 6 (c) (1) – (3 –)

A. Definition – Section 280 F (d) (4);Reg. Sec. 1.280 F – 6 (b))

- 2. Any of the property used as a means of transportation including trucks, buses, trains, boats, airplanes, motorcycles and any other vehicles for transporting persons or goods but not any qualified nonpersonal use vehicles.

- 3. Any property generally used for entertainment, recreation, or amusement purposes including property such as photographic, photographic, communication and video recording equipment. (See Section 280 F (d) (4) (A) (iii))

- 4. Computers are no longer considered listed property effective January 1, 2018.

B. Substantiation – Section 280 F (d) (4)

- 1. The documentation required to substantiate the business use of listed property generally includes the following:
  - The amount of each separate expenditure with respect to an item of listed property. This would include the cost of acquisition, cost of capital improvement, lease payments, cost of maintenance, cost of repairs or other expenditures or use.
  - The amount of each business investment use based on some appropriate measure. For automobiles that would be mileage.
  - The date of each expenditure or use
  - The business purpose for each expenditure or use.

- 2. Section 274 (d) impose a strict substantiation requirements for certain expenses such as automobiles. (See Reg. Sec. 1.274 – 5 T (a)). To substantiate by adequate records, the taxpayer must provide:
  - An account book, log or similar record and
  - Documentary evidence, which together are sufficient to establish each element with respect to an expenditure

B. Substantiation – Section 280 F (d) (4)

- 3. Section 274 (d) indicates that no deduction or credit shall be allowed on the basis of mere approximations or guesstimates. Generally it requires a contemporaneous writing. However, if it is not contemporaneous then other sufficient credible evidence is required to support a taxpayer's deduction. Other sufficient corroborating evidence can include the taxpayer's own statements, written or oral, containing specific information in detail as to such elements and other evidence sufficient to establish the deduction. Such evidence must be direct evidence, written or oral, to demonstrate elements of cost, amount, time, place or date of the expenditure or use thereof.

- 4. If the taxpayer's records are destroyed due to fire, flood, earthquake or other casualty, the taxpayer may reconstruct the expenses using a reasonable method. (See Reg. Sec. 1.274 – 5T (c) (5))

Examples

- **PM Anderson c. Comm., TC Memo 2024 – 95**. A married couple was not entitled to claim various Schedules C, Profit or Loss From Business, and Schedules E, Supplemental Income and Loss, expenses due to lack of substantiation. The IRS had no record of returns for those years and prepared substitutes for returns for the taxpayers. The taxpayers principally relied on accounting documents (cash disbursements journals and account registers) to substantiate reported business expenses. Further, the taxpayers explained the absence of additional evidence of actual payments on the grounds that the boxes containing that evidence were too voluminous to produce or the evidence was tied up in other litigation. Since the taxpayers did not convince the Tax Court that evidence of payment that existed was unavailable to them due to circumstances beyond their control, the Tax Court did not accept the taxpayers' journals and registers as evidence of actual payment. Additionally, because proper record keeping was feasible and, apparently, proper records were maintained, the Tax Court declined to exercise its authority to estimate the taxpayers' expenditures. Moreover, the taxpayers were not entitled to net operating loss (NOL) carryovers for similar reasons.

Examples

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Examples

- Additionally, because proper record keeping was feasible and, apparently, proper records were maintained, the Tax Court declined to exercise its authority to estimate the taxpayers' expenditures. Moreover, the taxpayers were not entitled to net operating loss (NOL) carryovers for similar reasons.

Examples

- **Henry v. Comm., TC Memo 2024 – 79**. Taxpayer, who operated tax bill pay services and other businesses along with spouse/“tax specialist,” who offered so-called tax saving strategies, was denied business deductions for allegedly business-related gifts totaling thousands of dollars. While taxpayer claimed that gifts were in form of $25 gift cards which he gave to clients or prospective clients, he didn't prove he actually gave gift cards to clients, or if he did, whether they were limited to one per client (as per Section 274 (d) 's deduction limit for cost of any business gift to $25 per recipient per year). In fact, it appeared taxpayer may have used gift cards for personal expenses and nondeductible gifts, particularly when considering he was part of spouse's tax strategy presentations where she recommended clients give gift cards to relatives for write offs and stated it was “up to you” as to how many to give.

Examples

- **CR Pangelina v. Comm., TC Memo 2024 – 5.** The taxpayer was not entitled to various business deductions on Schedule C due to lack of substantiation. The taxpayer failed to meet the strict requirements of substantiation under Section 274. The bank records submitted by the taxpayer to substantiate various business deductions for the taxpayer’s business as a contractor did not meet the rules of substantiation. The profit loss statements provided by the taxpayer were insufficient and unreliable

B. Substantiation – Section 280 F (d) (4)

- **5. Automobile Expense**. A taxpayer may deduct vehicle expenses on the basis of actual cost or the standard mileage rate, provided he substantiates the amount of business mileage and the time and purpose of each use. (See Treas. Reg. § 1.274-5(j)(2)).

- a. The taxpayer generally must keep a contemporaneous mileage log or a similar record, such as a diary or trip sheets, that substantiates the extent to which the vehicle was actually used for business rather than personal purposes. (See Temp. Treas. Reg. § 1.274-5T(b)(6)(i)(B), (c))

- b. Expenses for traveling between one's home and one's place of business or employment constitute commuting expenses and, consequently, are nondeductible personal expenses.(See Bogue v. Commissioner, T.C. Memo. 2011-164 [2011 RIA TC Memo ¶2011-164],2011 WL 2709818, at *5, aff'd, 522 F. App'x 169 [111 AFTR 2d 2013-2179] (3d Cir. 2013) ; see also § 262(a); Commissioner v. Flowers, 326 U.S. at 469-70; Feistman v. Commissioner, 63 T.C. 129, 134 (1974))

B. Substantiation – Section 280 F (d) (4)

- c. The cost of commuting is generally considered a personal expense. However, there are 3 exceptions to this rule. These include the following:
  - When a taxpayer has a home office, travel from that home office is considered a business expense.
  - Traveling between the taxpayer's residence in a temporary work location outside the metropolitan area where the taxpayer normally lives and works is not considered commuting.
  - Travel expenses between the taxpayer's residence interpret work locations, regardless of the distance, are deductible if the taxpayer also has one or more regular work locations away for the taxpayers residence. (See Bogue v. Comm., TC Memo 2011 – 184)

Examples

- **RM Ottuso v. Comm., TC Memo 2024 – 91**. An individual was not entitled to deduct gasoline expenses due to lack of substantiation. The taxpayer operated a store. However, the taxpayer did not offer any contemporaneous records of how the store's three vehicles. The taxpayer did not provide any corroborative evidence to support his assertion that the vehicles were used exclusively for business purposes. Moreover, the record contained no detailed descriptions or photographs of the vehicles. Consequently, the taxpayer failed to satisfy the strict substantiation requirements.

Examples

- **Midwest Medical Aesthetics Center, TC Memo 2024 – 32**. The taxpayer a corporation was not entitled to deduct automobile expenses due to a lack of substantiation. Specifically, the taxpayer failed to substantiate the business purpose of the vehicles. The directors had listed the vehicles as personal assets on two separate loan applications but the expenses were reported on Form 1120. The taxpayers were also denied deductions for a laser it acquired under a long-term lease agreement. Service disallow the depreciation on it the taxpayers claimed it had purchased a second laser however, they did not provide any documentation as to the purchase. Also, the taxpayer was not allowed to take a depreciation deduction for furniture it purchased because the furniture did not have the business purpose new furniture was installed in the directors home.

Examples

- **Aulisio, Jr. v. Comm., TC Memo 2024 – 29**. Taxpayer was not entitled to automobile expense deductions above amounts the IRS conceded related to his CPA business. The taxpayer did not provide contemporaneous records completely. Although the taxpayer offered testimony along with counter showing names of clients he met with plus mileage logs the records indicated that neither the calendar the laws were contemporaneous. Documents created after the expenditures were incurred had less probative value.

- **Steward v. Comm., TC Summary Opinion 2024 – 3**. The taxpayer, a musician, had his contemporaneous automobile log destroyed by a fire but was able to deduct automobile expenses based on reconstruction.

Examples

- **Chappell v. Comm., TC Summary Opinion 2024 – 2**. The Tax Court disallowed automobile expenses of the taxpayer because the taxpayer failed to meet the strict substantiation rules but in the alternative, the taxpayer was allowed the standard mileage rate based on mileage logs but only to the extent that the business purpose was self-evident. Taxpayers must substantiate (1) the amount of the expense; (2) the amount of total use and business use of the listed property during the year; (3) the date of each expense or the use of the listed property; and (4) the business purpose of the expense or use. A contemporaneous log as well as supporting evidence must be maintained. the taxpayer used a cellphone application called MileIQ to record her car trips. MileIQ used GPS office and home on her phone to track starting and stopping points and mileage. At the end of each trip, she would designate the trip as business or personal.

Examples

- MileIQ compiled the information into a spreadsheet. The MileIQ log showed 13,585.8 miles as business and 1,619 as personal but did not show the purpose of each trip. Before trial, the taxpayer prepared an edited version of the MileIQ log, and the number of business miles listed was less than the MileIQ log by 1,987.6 miles. The modified log included a short description of the purpose of each trip. She had one car, and the receipts often showed two or three same-day gas purchases on days when the mileage logs did not show an excessive number of miles being driven. Because of the inconsistencies in the records, the court allowed the taxpayer a standard mileage rate deduction for the trips where the business purpose was evident, instead of determining the deduction based on the actual vehicle expenses.

B. Substantiation – Section 280 F (d) (4)

- 6. Travel Expenses. The section 274 substantiation rules as to time, location and business purpose also apprised to each travel expense. Reconstructed travel logs will be allowed in the event the records were destroyed. That is still no guarantee that the deduction will be allowed. (See Jadhav v. Comm., TC Memo 2023 – 140.)

V. Automobile Expenses

A. Standard Mileage Rate

- 1. For 2024, the standard mileage rate for deductible business expenses is $0.67 per mile. (Notice 2024 – 8)

B. Depreciation Limits for Passenger Automobiles

- 1. Luxury Auto Depreciation Caps – Rev. Proc. 2024 – 13. The luxury car depreciation caps for a passenger car, sports utility vehicle, truck or van placed in service in 2024 limit the annual depreciation deduction as follows:
  - 12,400 for the first year without bonus depreciation
  - $20,400 for the first year with bonus depreciation
  - $19,800 for the second year
  - $11,900 for the third year
  - $7,160 for the fourth through sixth year

- 2. Access Depreciation on Luxury Vehicles. If depreciation exceeds the annual cap, the excess depreciation is deducted beginning in the year after the vehicle's regular depreciation period ends. The annual cap for this excess depreciation is:
  - $7,160 for passenger cars and
  - $7,160 for SUVS, trucks, and vans.

- 3. Least Inclusion Amounts for cars, SUVs, Trucks and Vans. If a vehicle is first leased in 2024, a taxpayer must add a lease inclusion amount to gross income in each year of the lease if its fair market value at the time of the lease is more than:
  - $62,000 for a passenger car, or
  - $64,000 for an SUV, truck or van.

VI. Transportation and Lodging

A. Lodging: Notice 2024 – 68: High low per diem method for Lodging, meals and incidental per diem rates.

- 1. The Service has announced the special per diem rates used to substantiate ordinary and necessary business expenses of travel away from home. The new rates start October 1, 2024. Obviously, in lieu of actual lodging, meals and incidental expenses incurred, a pay or may consider substantiated for federal tax purposes and employees expenses incurred for employment related travel in an amount up to or equal to the federal per diem rate for the locality of travel.

- 2. The substantiation method applies for travel within the continental United States (CONUS).

- 3. The rate for travel to high-cost localities within CONUS is $319, and the rate for non-high-cost localities will be $225. The current rates for the period Oct. 1, 2023, to Sept. 30, 2024, are, respectively, $309 and $214. The portion of the rates treated as paid for meals for purposes of Sec. 274(n) will also be higher: $86 for high-cost CONUS localities and $74 for all other CONUS localities.

A. Lodging: Notice 2024 – 68: High low per diem method for Lodging, meals and incidental per diem rates.

- 4. The notice revised the list of high-cost localities for the upcoming new annual period (Oct. 1, 2024, to Sept. 30, 2025) for which the new rates are in effect. High-cost localities have a federal per-diem rate of $272 or more. Los Angeles has been added to the list of high-cost localities for the new period after it was removed from the high-cost list last year.

- 5. he notice also provides special rates for taxpayers in the transportation industry. The meals and incidental expenses rates are $80 for any locality of travel within CONUS and $86 for localities of travel outside CONUS, both the same as the current rates.

A. Lodging: Notice 2024 – 68: High low per diem method for Lodging, meals and incidental per diem rates.

- 6. The rate for incidental expenses remains $5 per day for travel in and outside CONUS.

- 7. The domestic per diem rates can be found at www.gsa.gov

B. Qualified Transportation Fringe Benefit

- 1. For tax years beginning in 2024, the monthly limit regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and transit pass is $315. (Rev. Proc. 2023 – 34)

- 2. For the tax years beginning in 2025, the monthly limit regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and a transit passes $325. (Rev. Proc. 2024 – 40)

VII. Business Interest Expense Limitation

A. Rule

- 1. Under the Tax Cuts and Jobs Act, for tax years beginning after 2017 the deduction for business interest expense cannot exceed the sum of the taxpayer's:
  - Business interest income for the tax year;
  - 30% of adjusted taxable income (ATI) for the year, or zero if the taxpayer's ATI is less than zero; and
  - Floor plan financing interest expense (Sec. 163(j); Prop. Regs. Sec. 1.163(j)-2(b)).
- 2. One of the adjustments to arrive at ATI is an addback of depreciation, amortization, and depletion deductions. However, this addback is removed for tax years beginning after January 1, 2023, under the Tax Cuts and Jobs Act (TCJA).
- 4. The Sec. 163(j) limitation applies only to business interest expense that would otherwise be deductible in the current tax year (Prop. Regs. Sec. 1.163(j)-3(b)(1)).

Example

- **Cardulla v. Comm., TC Memo 2023 – 89**. Taxpayer was an LLC claim he can deduct interest expense payments accrued on a secured note. The IRS argued that the interest expense should be denied entirely because the note did not represent a bona fide loan establishing a debtor creditor relationship. Specifically, the note was for a fixed sum included interest and was to be paid by certain date showed that it fact was bona fide. The service was correct in that the debt instrument did have an original issue discount. In addition, and without an accounting method change the Inc. LLC could not accrue interest on the note during the years under the OID rules. The interest on the note even if it was allowed would been subject to the business interest expense limitations.

VIII. Final Regulations on Business Meals and Entertainment – TD 9925; Reg §1.274-11, Reg §1.274-12; . IR 2020-225

A. Food and Beverage

- 1. The regulations clarify the treatment of business deductions for food and beverages are generally limited to deduction of 50% of qualifying expenditures. The regulations also discuss how taxpayers may distinguish those expenditures from entertainment.
- 2. Section 274(a)(1)(A) generally disallows a deduction for any activity of a type generally considered entertainment, amusement, or recreation. Entertainment expenses were previously allowable before their deletion by the Tax Cuts and Jobs Act (TCJA). The Act repealed the requirement that the expenses directly relate to or are otherwise associated with the conduct of a trade or business. The Act retained the substantiation requirements for food and beverage as well as meals and lodging away from home.

A. Food and Beverage

- 3. The final regulations indicate that no deduction is allowed for the expense of any food and beverage provided by the taxpayer or an employee of the taxpayer to any person (s) unless:
  - The expense is not lavish or extravagant under the circumstances;
  - The taxpayer, or employee the taxpayer, is present at the furnishing of the food or beverages; and
  - The food or beverages are provided to a business associate. (See Reg. Sec. 1.274 – 12 (a) (1) (i-iii))

A. Food and Beverage

- 4. The definition of food and beverage refers to all food and beverage items regardless of whether there characterizes meals, snacks or other types and regardless of whether they are considered a de minimis fringe benefit under Section 132 (e). The definition does refer to the full cost of the food or beverage as well as delivery fees, tips and sales tax. The definition does not include the expenses for the operation of an eating facility such as salaries of employees preparing and serving meals and other overhead costs. Those are deductible but not part of the 50% limitation.

- 5. The deduction for food and beverage relates to business associates. A business associate refers to a person with of the taxpayer could reasonably expect to engage or deal the active conduct of the trade or business of the taxpayer. This could include customers, clients, vendors, employees, agents, professional advisors, independent contractors. In essence, a meal with just the taxpayer an employee qualifies for the deduction. Business associates includes employees.

Example

- Taxpayer A takes a client out to lunch. A can deduct 50% of the meals at lunch. The same scenario would be if They took an employee out to lunch to discuss business or to conduct a performance review in relation to work.

A. Food and Beverage

- 6. The final regulations apply this definition to employer-provided food or beverage expenses by considering employees as a type of business associate, as well as to the deduction for expenses for meals provided by a taxpayer to both employees and nonemployee business associates at the same event.

- **Kalk v. Comm., TC Memo 2024 – 82**. Taxpayer, a sole proprietor was not allowed to deduct meal expenses incurred in daily working luncheons with person she worked for and the developer she was contracted to work for. The taxpayer did not substantiate the expenses in question. She only provided bank statements and credit card statements that did not establish a business relationship or business purpose with whom she was having lunch.

Example

- Taxpayer A holds a business meeting at a hotel during which food and beverages are provided to all the attendees. The expenses for the business meeting other than the food and beverage are not subject to the deduction limitations in Section 274 and are deductible if they meet the requirements to be deducted as an ordinary and necessary business expense. Now assume the same facts except the attendees are all employees of the taxpayer. Expenses for the business meeting, other than the cost of food and beverage, are not subject to the deduction limits and are deductible if they are ordinary and necessary nature.

A. Food and Beverage

- 7. The TCJA also applied the 50% limitation on food or beverages to de minimis fringe employee benefits under Sec. 132(e) (unless another exception under Sec. 274(e) applies), which formerly were not subject to it. Thus, business taxpayers must separate deductible meal expenses from nondeductible entertainment expenses, and the regulations address how this is done in a variety of circumstances.

B. Entertainment

- 1. The final regulations indicate that entertainment means an activity which is of a type generally considered to constitute entertainment, amusement or recreation such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or taxpayers family. These activities are treated as entertainment subject to the objective test, irrespective of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business.

- 2. The term entertainment may include an activity, the cost of which otherwise is a business expense of the taxpayer, which satisfies the personal, living or family needs of any individual such as providing a hotel suite or automobile to a business customer or the customer's family.

B. Entertainment

- 3. The term entertainment does not include activities which, although personally satisfying, living or meeting family needs of an individual, are clearly not regarded as constituting entertainment such as the providing of a hotel room maintained by an employer for employees while traveling on business or automobile used in the active conduct of a trade or business even though used for routine personal purposes such as commuting to and from work.

B. Entertainment

- 4. The regulations clarify that entertainment for purposes of Sec. 274(a) does not include food or beverages unless they are provided at or during an entertainment activity and their costs are not separately stated from the entertainment costs. Food or beverages provided at or during entertainment activity generally are generally treated as part of the entertainment activity. The food or beverage are not considered entertainment if such food or beverages are purchased separately from the entertainment or the cost of them stated separately from the cost of the entertainment on a bill, receipt or invoice. If the food or beverage are not separately stated from the entertainment or they are not paid separately no allocation may be made.

- 5. The providing of a hotel or automobile by an employer to an employee on vacation constitutes entertainment and is not deductible. The term entertainment does not include food and beverage unless the food or beverages are provided at or during entertainment activity.

Examples

- Taxpayer A invite B, a business associate to a baseball game to discuss a proposed business transaction. A purchases tickets for both parties to attend again. The baseball game is entertainment and the cost of the tickets are not deductible by taxpayer A.

- Assume the same facts except that A buy food and beverage from a concession stand for both himself and B. The food and beverage are purchased separately from the game tickets and that is deductible subject to the 50% limitation.

Examples

- Taxpayer A invite B, a business associate, to a basketball game. A purchases tickets for both parties to attend the game in a box suite for that access to food and beverages. The cost of the basketball game tickets as stated on the invoice includes all food and beverage. The basketball game is entertainment and the cost of the tickets is not deductible. The cost of the food and beverages are not purchased separately from the tickets and are not separately stated as such, they are not deductible and considered part of entertainment.

C. Meals While Traveling

- 1. Food or beverage expenses paid or incurred while traveling away from home in the pursuit of a trade or business are subject to the limitations as well as the substantiation requirements under Section 274. Generally, no deductions allowed for the expense of any food or beverage paid or incurred while traveling away from home to the pursuit of a trade or business unless the taxpayer meets the substantiation requirements. This provision includes travel and meals regarding a spouse or dependent or other individuals accompanying the taxpayer as a general.

- 2. The Final regulations clarify that under Section 274 (m) travel expenses paid or incurred with respect to a spouse, dependent or other individual or company the taxpayer on a business travel situation are not deductible unless:
  - the spouse, dependent or other individual is an employee of the taxpayer;
  - the spouse, dependent or other individual is involved in a bona fide business purpose associated with the taxpayer; and
  - the expenses would otherwise be deductible by the spouse, dependent or other individual (ordinary and necessary business expense).

D. Section 274 (e); Exceptions to Section 274 (k) and (n)

- 1. i. The TCJA did not repeal other exceptions under Secs. 274(e)(1) through (9), including, for example, certain recreational activities for the benefit of employees, reimbursed expenses, and entertainment treated as compensation to an employee or includible in gross income of a nonemployee as compensation for services or as a prize or award (and reported by the taxpayer as such). (See Reg. Sec. 1.274 – 12 (c)).

- 2. The exceptions to the 50% limitation are associated with the following:
  - Expenses treated as compensation – Section 274 (e) (2);
  - Reimbursed expenses – Section 274 (e) (3);
  - Recreational, etc., expenses for employees – Section 274 (e) (4);
  - Items available to the public – Section 274 (e) (7);
  - Entertainment sold to customers – Section 274 (e) (8);
  - Expenses includible in income of persons who are not employees – Section 274 (e) (9).

D. Section 274 (e); Exceptions to Section 274 (k) and (n)

- 3. To clarify, disallowance of a deduction for expenses related to business entertainment shall not apply to any expenses associated with
  - Entertainment related providing food or beverage primarily to employees – Section 274 (e) (1)
  - Expenses directly related to business meetings for employees and business associates – Section 274 (e) (5)
  - Expenses directly related and necessary to attendance at a business meeting or convention – Section 274 (e) (6).

E. Expenses Treated as Compensation – Section 274 (e) (2)

- 1. Any expense paid or incurred by a taxpayer for food or beverages, including food or beverages provided during travel, if an employee is the recipient of the food or beverages, is not subject to the deduction limitations to the extent that the expense is treated by the taxpayer:
  - On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and
  - As wages to the employee for purposes of withholding relating to collection of income tax at source on wages (See Section274(e)(2); Reg. Sec. 1.274-12(c)(2)(i)(A)(1) & (2)).

- 2. The final regulations do provide for treatment of non accountable plans whereby the 50% limitation will not apply to an expense paid or incurred by taxpayer for food or beverage if the employee receives it as compensation or as an independent contractor. (Nonaccountable Plan)

Examples

- Employer provides food and beverages to employees without charge at the company cafeteria located on its business premises. The food and beverage does not meet the de minimis fringe benefit criteria. As such the employer treats the full fair market value of the food and beverage as compensation to the employees. The expenses associated with the food and beverages are not subject to the 50% deduction limitation. The employer may deduct 100% of these expenses.

- Now assume that the employer pays each employee $8 a day for food and beverage where the average fair market value of that provision is $10 per day per employee. The employer incurs $9 per day for the food and beverage. The employer will treat the food and beverage expense as compensation to the extent of the difference between the fair market value ($10) and the reimbursed amount ($8), meaning the employer would include $2 per day for each employee as compensation. The employer may deduct the $9 per day per employee.

F. Reimbursed Arrangements – Section 274 (e) (3);

- **1. Employees and Independent Contractors**

- a. In the case of an employer reimbursing employees for food and beverage incurred in the performance of their duties as employees, whether or not his compensation is based upon whether there's an accountable plan in place or a non-accountable plan in place. The arrangement is associated with an employee or independent contractor receiving an allowance, advance or reimbursement from the pay or for expenses the employee or independent contractor pays or incurs.

F. Reimbursed Arrangements – Section 274 (e) (3);

- b. There must be a written agreement between the parties expressly s stating that the client or customer will reimburse the employer independent contractor for expenses that are of the subject to the limitations discussed herein or the agreement between the parties expressly identifies the parties subject to the limitations. (Accountable Plan)

- c. In the case of food or beverages paid or incurred by employee in performing services as an employee under a reimbursement for expense allowance arrangement the limitation on the deduction for the food or beverage applies to the employee to the extent the employer treats the reimbursement as compensation or non-compensation depending on writing in the arrangement.

F. Reimbursed Arrangements – Section 274 (e) (3);

- d. With regards to independent contractors, expenses for food and beverages paid or incurred by an independent contractor in connection with performance of services for a client under a reimbursement arrangement, the limitation on the deduction applies to the party expressly identified in the agreement of reimbursement. If the agreement does not expressly identify a party subject to the deduction limitations then the limitation applies to the independent contractor to the extent the independent contractor does not account to the client or to the client if the independent contractor accounts to the client under the provisions.

- e. If the reimbursement or expense allowance arrangement involves individuals who are not employees and the agreement does not expressly identify the parties subject to the deduction limitation, the limitation on the deduction shall apply to the independent contractor unless the independent contractor accounts to the client with substantiation under Section 274 (d) rules.

G. Recreational Expenses for Employees -Section 274 (e) (4)

- 1. Any food or beverage expense paid or incurred by taxpayer for recreational, social or similar activity primarily for the benefit of the taxpayers employees (other than employees who are highly compensated employees) is not subject to the deduction limits.

- 2. However, activities that discriminate in favor of highly compensated employees, officers, shareholders, directors or others who only 10% or greater interest in the business are not considered paid or incurred primarily for the benefit of the employees.

Examples

- Employer invites all employees to a holiday party at a hotel ballroom. The party includes dinner and open bar. The cost of the party, including food and beverage expenses is not subject to the deduction limitations of this section because the holiday party is recreational, social or similar activity the primarily for the benefit of non highly compensated employees. The employer may deduct 100% of the cost of the party – yes!

G. Recreational Expenses for Employees -Section 274 (e) (4)

- 3. In essence, the exception applies the company holiday parties, annual picnics, Christmas dinners, summer outings that do not discriminate in favor of highly compensated employees. Since these food or beverages are, furnished for the employee's convenience, they cannot also be primarily for the benefit of the employees even if some social activity occurs during the provision of the food or beverage.

- **4. Employer Provided Snacks**. Employer provides free coffee, soda, bottled water, chips, donuts and other snacks in a breakroom available to all employees at work. A breakroom is not a recreational, social similar activity primarily for the benefit of the employees even if some socialization related to the food and beverage occurs. This is not considered an exception the employer may deduct only 50% of the food and beverage provided in the break room. (This illustration may be counter to IRS Publication 15 – B which allows an employer to exclude an occasional meal provided to employee if it is so little value that accounting for would-be unreasonable or administratively impractical.)

G. Recreational Expenses for Employees -Section 274 (e) (4)

- **5. Emergency Call** Employer has a written policy that certain employees must be available for emergency calls due to the nature of the work that they must do. Often these emergencies and emergency cost can occur during a meal time. The employer furnishes food and beverages to the employees in this position without charge in a cafeteria on its premises. Employer excludes the food and beverages from the employee's income as meals provided for the convenience of the employer. Since this study beverages are furnished for the employer's convenience and are not primarily for the benefit of the employees the exception does not apply even if some socialization related to the incurrence of the food and beverages occurs. The employer may only deduct 50% of the food and beverages provided to the employees in the cafeteria setting.

H. General Public – Section 274 (e) (7)

- 1. Expenses paid or incurred by taxpayer for food or beverage available to the general public is not subject to the limitations of 50%. If the taxpayer provides food or beverages to employees this exception applies to the entire amount of such expenses if the same type of food or beverage is provided to an primarily consumed by the general public.

Examples

- Employer P is a real estate agent and provides refreshments at an open house for a home available for sale to the public. The refreshments are consumed by P's employees, potential buyers of the property, and other real estate agents. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations in paragraph (a) of this section if P determines that over 50 percent of the food and beverages are actually or reasonably estimated to be consumed by potential buyers and other real estate agents. If more than 50 percent of the food and beverages are not actually or reasonably estimated to be consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply to the expenses associated with the refreshments that are not excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

Examples

- Employer Q is an automobile service center and provides refreshments in its waiting area. The refreshments are consumed by Q’s employees and customers, and Q reasonably estimates that more than 50 percent of the refreshments are consumed by customers. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations provided for in paragraph (a) of this section because the food and beverages are primarily consumed by customers. Thus, Q may deduct 100 percent of the food and beverage expenses.

IX. Accounting Method

A. General

- 1. The Tax Cuts and Jobs Act expands the universe of taxpayers that can use the cash method of accounting for C Corporations (and partnerships with the C corporation as a partner) and as well as the provision specific to forming businesses of C Corporations and provisions concerning the use of inventory.

- 2. The Act amends Section 448 (b)(3) to require that a C corporation (or partnership with a C corporation as a partner), or any predecessor to meet the gross receipts test for the tax year rather than all prior tax years beginning after December 31, 1985 and amends Section 448(c)(1), which provides the gross receipts test to refer to the tax year rather than prior tax years.

A. General

- a. In other words, the gross receipts test must be satisfied only for the tax year for which the taxpayer seeks to use the cash method and not all earlier tax years that begin after 1985.

- 3. Under the Act the gross-receipts test is satisfied for the tax year if the average annual gross receipts are under the prescribed dollar limit for the three tax-year period ending with the tax year that precedes the tax year for which the taxpayer is being tested.

B. Gross Receipts Exception

- 1. For 2024, the gross receipts exception will be $ 30 million, (See Rev. Proc. 2023-.34)

- 2. For 2025, the gross receipts exception will be $ 31 million, (See Rev. Proc. 2024-.40)

C. Small Business Exception

- 1. Taxpayers that qualify as small businesses under Section 448 (c) are eligible for exceptions to the number of rules. The exceptions to the limitations include the following:
  - The business interest expense limitation.
  - The requirement that direct and certain indirect costs allocable to real or tangible personal property produced by the taxpayer be capitalized into the basis of the property.
  - The prohibition of the use of the cash method of accounting for C Corporations.
  - The requirement that taxable income from a long-term contract be determined under the percentage of completion method.
  - The requirement to maintain inventory under Section 471.
- 2. The small business exception qualification is satisfied if the above gross receipts test is met.

D. Automatic Changes in Tax Accounting Methods – Rev. Proc. 2024 – 23

- 1. The revenue procedure detailed many changes to the list of automatic changes in accounting methods used on Form 3115. The changes included matters associated with:

D. Automatic Changes in Tax Accounting Methods – Rev. Proc. 2024 – 23

- Upfront payments for network upgrades received by utilities
- Commodity Credit Loans treatment
- Attorney advances on behalf of clients
- Materials and Supplies, Repair and maintenance costs
- Change from Reserve Method to Specific Charge-off method
- Amortization and Interest Expense of Bond Premiums
- Depreciation and Amortization – impermissible to permissible methods
- Deduction for Energy Efficient Commercial Building
- Software Expenditures
- Change in Method of Accounting for SRE expenditures
- Startup Expenditures and organizational fees
- Capital Expenditures and various items
- Losses Expenses and Interest with regards to Related Party Transactions

D. Automatic Changes in Tax Accounting Methods – Rev. Proc. 2024 – 23

- Deferred Compensation Matters
- Methods of Accounting – Cash to Accrual, Nonaccrual Method, film producers treatment, warranty costs, Hybrid Methods for banks, farmers,
- Taxable Year of Inclusion Items
- Obligations Issued at Discount
- Prepaid Subscription Income
- Long term contract matters
- Inventory Issues – capturing huge
- LIFO Issues
- Mark to Market Accounting
- Discounted Unpaid Losses
- Functional Currency
- REMIC Fees
- Market Discount Bonds

D. Automatic Changes in Tax Accounting Methods – Rev. Proc. 2024 – 23

- 2. Each method change is given a designated automatic accounting method change number for use in completing form 3115.

- 3. The Revenue Procedure is effective for form 3115 filed on or after April 30, 2024 for a year of change ending on or after September 30, 2023 that is filed under the automatic procedures.

X. R&E Expenditures

A. General Rule

- 1. Effective for amounts paid or incurred in tax years beginning after December 31, 2021, taxpayers may no longer deduct research and experimental (R&E) expenditures currently under Section 174 but must amortize them over five years or longer. This change was enacted in late 2017 by the law known as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97.

- 2. The five-year amortization period begins at the midpoint of the tax year in which the expenditures are paid or incurred regardless of when the taxpayer begins to realize income from its R&E expenditures.

A. General Rule

- 3. The amortization period is 15 years for R&E expenditures attributable to "foreign research," as defined in Sec. 41(d)(4)(F). This section provides the tax credit for increasing research activities. "Qualified research" expenses for Sec. 41 purposes are defined, in part, as costs that may be treated as expenditures under Sec. 174.

- 4. R&E expenditures subject to amortization now include those in connection with the development of any software (See Sec. 174(c)(3), added by the TCJA).

B. Interim Guidance For Specific Research or Experimental (SRE) expenditures – Rev. Proc. 2024 – 9 and Notice 2024 – 12.

- 1. Rev. Proc. 2024 – 9 contains procedural guidance and Notice 2012 – 12 substantive guidance.

- 2. Notice 2024 – 12 provides clarification in the following areas:

- a. Contract research and excluded SRE product rights: Under prior Notice 2023-63, for research performed under contract, the research provider's exposure to capitalization under Sec. 174 was fairly broad and generally triggered by either financial risk or any right to use or exploit the SRE product. Notice 2024-12 limits this exposure for research providers that do not bear financial risk under their contract terms and obtain only an "excluded SRE product right," which is either separately bargained for or acquired for the limited purposes of performing SRE activities for the research recipient.

B. Interim Guidance For Specific Research or Experimental (SRE) expenditures – Rev. Proc. 2024 – 9 and Notice 2024 – 12.

- b. Limited reliance for Notice 2023-63: As initially released, Notice 2023-63 contained an all-or nothing reliance provision: To rely on any of the rules in the notice, taxpayers had to rely on them all. Notice 2024-12 removes the all-or-nothing requirement; taxpayers may now choose the provisions of Notice 2023-63 on which they would like to rely.

- c. Rev. Proc. 2000-50 available for pre-2022 software development costs: Notice 2024-12 clarifies that Section 5 of Rev. Proc. 2000-50 regarding costs of developing computer software is obsoleted only for expenditures paid or incurred in tax years beginning after December 31, 2021, not for earlier expenditures.

B. Interim Guidance For Specific Research or Experimental (SRE) expenditures – Rev. Proc. 2024 – 9 and Notice 2024 – 12.

- 3. The notice also addressed taxpayers with SRE expenditures allocable to long-term contacts accounted for under the percentage-of-completion method (PCM), the Service clarified in Notice 2023-63 that the numerator of the completion ratio contained the amortization of the SRE expenditure, not its gross amount. That prevented the whipsaw effect of contract revenue acceleration accompanied by a deferral of the corresponding expenses.

- 4. Rev. Proc. 2024-9 is the fourth iteration of procedural guidance granting automatic IRS consent for accounting method changes to comply with the Sec. 174 amendment. The new procedural guidance introduced automatic method changes to conform with Notice 2023-63 as modified by Notice 2024-12 and is effective for Forms 3115filed on or after December 22, 2023.

B. Interim Guidance For Specific Research or Experimental (SRE) expenditures – Rev. Proc. 2024 – 9 and Notice 2024 – 12.

- 5. The Revenue Procedure also addressed pyrite durations he procedural guidance created DCN 265, providing automatic IRS consent for taxpayers to change their methods of accounting to comply with the Sec. 174 amendment. While maintaining the availability of DCN 265, Rev. Proc.2024-9 creates a second automatic change — DCN 270 — that is specific to compliance with Sections 3 through 7 of Notice 2023-63. Given that those sections of Notice 2023-63 are themselves nonmandatory interpretations of the Sec. 174 amendment, it is not entirely clear what circumstances would compel taxpayers to file a change under this second DCN 270 versus the original DCN 265. Rev. Proc.2024-9 also created a third DCN granting automatic IRS consent for taxpayers to conform with Section 8 of Notice 2023-63 concerning the interaction of Sec. 174 and the PCM. As with all DCNs implementing the Sec. 174 amendment, DCN 271 is made on a cutoff basis if filed for the taxpayer's first tax year beginning after Dec. 31, 2021. This particular cutoff is important because it is based on when the expenditure is incurred, not on the contracting date. For DCN 271s filed for subsequent years, however, the new guidance allows a modified Sec. 481(a) adjustment, which is a welcome surprise, given that the Service typically requires cutoff treatment for all PCM related changes.

B. Interim Guidance For Specific Research or Experimental (SRE) expenditures – Rev. Proc. 2024 – 9 and Notice 2024 – 12.

- 6. Under prior iterations of the procedural guidance, DCN 265 required a modified Sec. 481(a) adjustment for changes made after a taxpayer's first tax year beginning after Dec. 31, 2021. Rev. Proc. 2024-9 gives taxpayers the choice of implementing such changes on a cutoff basis if the modified Sec. 481(a) adjustment would be negative which is, representing an income reduction. This optional cutoff treatment is available for all three DCNs: 265, 270, and 271.

- 7. A taxpayer generally cannot use automatic consent procedures to change its method of accounting if it made or attempted an earlier accounting method change for the same item within a five year window. In earlier iterations, the IRS waived this five-year restriction for DCN 265s filed for a taxpayer's first tax year beginning after Dec. 31, 2021. Rev. Proc. 2024-9 expands this waiver for one additional tax year and allows the same waiver for DCNs 270 and 271.

C. Notice 2023 – 63 Amortization of R&E in the Event Company Terminates

- 1. Notice 2023 – 63 states that a sale or other disposition of specified research or experimental (SRE) property does not trigger acceleration of the deduction of the unamortized expenditures. It also does not permit the use of the unamortized expenditure amount in computing the gain or loss on the transfer.

- Example

- Company A, a calendar year taxpayer on the accrual method incurs SRE expenditures in 2023 for research performed in the US. On September 30, 2025, the company sells the property to Company B and recognizes gain. In 2025 through 2028 Company a rapidly advertises the remaining unamortized SRE expenses notwithstanding the fact that the company has disposed of said property. Company B does not amortize any portion of the SRE expenditures originally paid or incurred by Company A. Company A cannot factor the unamortized SRE expenditures in computing gain or loss.

C. Notice 2023 – 63 Amortization of R&E in the Event Company Terminates

- 2. The notice does state that on the disposition, retirement or abandonment of SRE property when a corporation ceases to exist generally this is associated with the reorganization or a liquidation.

- Example

- Company A ceases to exist for federal tax purposes, the acquiring corporation will continue to amortize the transferor's unamortized SRE expenditures over the remainder of the amortization timeframe beginning with the month of the transfer. The transferee inherits the ongoing amortization.

XI. Energy Efficient Commercial Buildings Deduction – Section 179D

A. Overview

- 1. The Inflation Reduction Act of 2022 made the deduction permanent and requires a building to increase its energy efficiency by 25% as opposed to 50%.

B. Deduction

- 1. For 2024, the maximum energy efficient commercial buildings deduction is changed to $0.57 per square foot but increased by $0.02 (not to exceed $1.13) for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent. Additionally, projects that meet prevailing wage and registered apprenticeship requirements, would get a bonus credit of $2.83, which would be increased by $0.11 for each percentage point increase in energy efficiency, with a maximum amount of $5.65 per square foot.

- 2. For 2025, the maximum energy efficient commercial building deduction is changed to $0.58 per square foot but increased by $ .02 cents (not to exceed a $1.16) for each percentage point by which the total annual energy and power costs of the building are certified to be reduced by percentage greater than 25%. Additionally, projects that meet prevailing wage and registered apprenticeship requirements would get a bonus credit of $2.90, which would be increased by $0.12 for each percentage point increase in energy efficiency with the maximum amount of $5.81 per square foot.

Example

- **Johnson v. US., 160 TC No. 2 (1/25/23).** The taxpayer was an S corporation in his engineering company was hired by the Veterans Administration to supply and install components of a federal building's HVAC system. The taxpayer analyzed existing technical programming specifications and modified them as necessary. The taxpayer then program modified specifications into new installed components. The taxpayer requested the VA to sign a letter agreeing to allocate the full amount of the energy efficient commercial building deduction to the taxpayer. This will be amount that the VA would otherwise be able to deduct had they been able to do so. The taxpayer claimed a deduction of that cost over multiple years. The court allowed the deduction starting in the year it was placed in service.

XII. Net Operating Losses

A. General Rule

- 1. Under Tax Cuts and Jobs Act, the amount of the NOL deduction was equal to the lesser of :
  - the aggregate of the NOL carryovers to such year and NOL carrybacks to such year, or
  - 80% of taxable income computed without regard to the deduction allowable in this section.

- 2. There is no carryback of the losses with 2 exceptions:

- a. Farming Losses may be carryback 2 years. The farming business may elect to forgo the carryback.

- b. Insurance Companies (other than life insurance companies) can carryback a loss 2 years and then any carryforward would be for 20 years.

B. Limitation on NOL

- 1. The taxpayer claiming an NOL deduction for tax year must file with the return for that tax year a statement setting forth the amount of the NOL deduction claimed including a detailed schedule showing the computation.

- 2. Taxpayers have the burden of establishing the existence of the loss and the amount that is carried to the years at issue. This is particularly the case now with NOL carryovers.

Example

- **Bryan Jr., v. Comm., TC Memo 2023 – 74.** The taxpayer gave an LLC a promissory note for $2.7 million with a single balloon payment due on or before December 31, 2030 and interest accruing at 4.75%. The note was not secured or collateralized. The LLC files as a partnership for the years at issue. The promissory note was not shown on the balance sheet of the LLC. The partnership gave an unrelated LLC a promissory note in the amount of $ 2.7 million in an exchange for a 20% interest in the partnership. Again, the note was not secured or collateralized by any assets and the interest rate accruing was at 4.75% neither the taxpayer nor the LLCs were personally liable for the loan. The LLC issued a K – 1 to the taxpayer showing a $3 million loss creating an NOL carryover. The Tax Court found the taxpayer did not have adequate basis was not at risk for either of these transactions and were thus not allowed the NOL deductions.

SECTION XI:

BENEFICIAL OWNERHSIP INFORMAION REPORTINGS

I. Overview

A. General

- 1. The Corporate Transparency Act was enacted in 2021 to enhance transparency in entity structures and ownerships to combat money laundering, tax fraud, and other illegal activities. The Corporate Transparency Act (CTA) establishes uniform beneficial ownership information reporting requirements for certain types of corporations, limited liability companies, and other similar entities created in or registered to do business in the U.S. The CTA authorizes FinCEN to collect that information and disclose it to authorized government authorities and financial institutions, subject to certain safeguards and controls.

- a. According to FinCen, the idea behind the reporting requirements are to make it harder for bad actors hide or benefit from their ill-gotten gains through shell companies or other opaque ownership structures.

- 2. Beneficial ownership information refers to identifying information about the individuals who directly or indirectly own or control a company.

A. General

- 3. According to FinCEN and as stated in the reporting the benefits of the Reporting is that it would significantly aid efforts to protect the U.S. financial system from illicit use. It would impede illicit actors' ability to use legal entities to conceal proceeds from criminal acts that undermine U.S. national security and foreign policy interests, such as corruption, human smuggling, drug and arms trafficking, and terrorist financing. For example, BOI can add critical data to financial analyses in law enforcement and tax investigations. It can also provide essential information to the intelligence and national security professionals who work to prevent terrorists, proliferators, and those who seek to undermine our democratic institutions or threaten other core U.S. interests from raising, hiding, or moving money in the United States through anonymous shell or front companies.

A. General

- 4. Part of the push for the Corporate Transparency Act (CTA) is that nations around the world have implemented or in the process of implementing similar beneficial ownership collection requirements to combat money laundering and prevent financial crimes. These initiatives appear to be aligned with international standards set by organizations such as the Financial Action Task Force, an intergovernmental organization. Some countries that have set up similar reporting requirements to the United States include the following:

A. General

- The United Kingdom has a public register of beneficial ownership, which was established as part of its commitment to combating money laundering and improving corporate transparency. Companies are required to disclose information about their beneficial owners and this information is accessible to the public.
- Canada has introduced measures to enhance transparency in corporate ownership. Companies are required to maintain a register of individuals with significant control, which includes beneficial ownership information. The information is provided to the relevant authorities, but it is not made public.
- Australia has implemented a beneficial ownership regime, requiring certain entities to provide information about their beneficial owners. The information is stored in a centralized register maintained by the Australian Securities and Investments Commission.
- France has established a register of beneficial ownership information for certain legal entities. The information is collected and maintained by the commercial court registry.

A. General

- The Netherlands has implemented measures to collect and maintain information on ultimate beneficial owners of legal entities. This information is registered with the country's Chamber of Commerce.

- Singapore has implemented measures to enhance transparency in corporate ownership. Certain companies are required to maintain a register of controllers, including beneficial owners, and provide this information to the nation's Accounting and Corporate Regulatory Authority.

- South Africa has introduced beneficial ownership disclosure requirements for certain types of legal entities. The information is maintained by the Companies and Intellectual Property Commission.

- The European Union has implemented its Fourth and Fifth Anti-Money Laundering Directives) related to the identification and disclosure of beneficial owners of corporations.

A. General

- 5. The regulations go into effect on January 1, 2024, requiring reporting companies to file reports with FinCEN.

- 6. There are 2 types of reporting companies:
  - Domestic reporting company: a corporation, limited liability company, or other entity created by the filing of documents with the secretary of state (or similar office) within the United States.
  - Foreign reporting company: a corporation, limited liability, or other entity formed under the law of a foreign jurisdiction and registered to do business in the United States.

B. Potential Access to Information

- 1. FinCEN will permit Federal, State, local, and Tribal officials, as well as certain foreign officials who submit a request through a U.S. Federal government agency, to obtain beneficial ownership information for authorized activities related to national security, intelligence, and law enforcement. Financial institutions will have access to beneficial ownership information in certain circumstances, with the consent of the reporting company. Those financial institutions' regulators will also have access to beneficial ownership information when they supervise the financial institutions.

- 2. Beneficial ownership information reported to FinCEN will be stored in a secure, non-public database using rigorous information security methods and controls typically used in the Federal government to protect non-classified yet sensitive information systems at the highest security level. FinCEN will work closely with those authorized to access beneficial ownership information to ensure that they understand their roles and responsibilities in using the reported information only for authorized purposes and handling in a way that protects its security and confidentiality.

II. Reporting Process

A. Timeline for Reporting

- 1. FinCEN opened up its reporting requirement on January 1, 2024. The filing is an electronic filing through https://boifiling.fincen.gov and then select ‘File BIOR”
- 2. Currently, a reporting company created or registered to do business before January 1, 2024, will have until January 1, 2025, to file its initial BOI report.
- 3. A reporting company created or registered in 2024 will have 90 calendar days to file after receiving actual or public notice that its creation or registration is effective.
- a. This 90-calendar day deadline runs from the time the company receives actual notice that its creation or registration is effective, or after a secretary of state or similar office first provides public notice of its creation or registration, whichever is earlier.

A. Timeline for Reporting

- 4. A reporting company created or registered on or after January 1, 2025, will have 30 calendar days to file after receiving actual or public notice that its creation or registration is effective.

- 5. Presently, there is no fee for submitting the report.

B. Who Can File A BOI Report

- 1. The company that files the report is known as the Reporting Company.
- 2. Anyone whom the Reporting Company authorized to act on its behalf may file the report. This can include an officer, director, owner, employee, third party service provider. The filer must provide basic contact information including name, email address and phone number.
- 3. Attorneys and CPAs may assist in the reporting but there is no mandate or requirement that an attorney or CPA submit.
- 4. Note: It is imperative that CPA and CPA firms ascertain from their malpractice carrier as to whether they will be covered under the field of accounting in terms of filing the form. Many CPAs and CPA firms have been advised by their liability carriers that they will not be covered for filing the report. As such, a CPA with a liability policy should not assume that they are covered.

C. Preparing for Beneficial Ownership Reporting

- 1. Organizations should take proactive steps to prepare themselves to meet beneficial ownership reporting requirements.
- **2. Internal Review**: Conduct an internal review of your company's structure and ownership hierarchy to identify all potential beneficial owners.
- **3. Documentation Gathering**: Collect the necessary documentation and information for each beneficial owner and company applicant, such as identification documents, proof of address, and relevant corporate records. The corporate records would include bylaws, buy sell agreements, minutes, policies and procedures, employment agreements, restrictive transfer agreements at a minimum.
- **4. Centralized Record-Keeping**: Establish a centralized system or database to record and maintain accurate beneficial ownership information.

C. Preparing for Beneficial Ownership Reporting

- **5. Regular Updates**: Ensure your records are up-to-date by periodically reviewing and verifying the provided information. This is particularly the case regarding minutes as they would be examined in determining beneficial ownership reporting..

- **6. Documentation for Exemption from Reporting**. Only a newly exempt entity is required to do a submission. For those that are exempt going into the reporting process internal documentation is necessary. It is strongly recommended that you download the Small Entity Compliance Guide and fill out the questions associated with your exempt entity. These are listed under Section 1.2 of the guide.

- **7. Documentation of Substantial Control**. It is strongly recommended that you download the Small Entity Compliance Guide and examine the questions regarding Substantial control listed on page 20. The above referenced documents should also be centralized for this process.

III. Reporting Company

A. Reporting Companies

- 1. The entity that is required report is known as a Reporting Company.
- 2. Companies, businesses or entities are required to report only if they meet the reporting company definition of a Reporting Company and do not qualify for an exception.
- 3. Generally, there are 2 types of reporting companies:
  - Domestic reporting company: a corporation, limited liability company, or other entity created by the filing of documents with the secretary of state (or similar office) within the United States.
  - Foreign reporting company: a corporation, limited liability, or other entity formed under the law of a foreign jurisdiction and registered to do business in the United States.
- a. If the company is neither of these two types of reporting companies then it is not required to have a report filing.

A. Reporting Companies

- **4. Domestic Reporting Companies**. A domestic reporting company is entity that is formed under the laws of United States or Indian tribes as the case may be. A Domestic Reporting Company can include a corporation, LLC or other entity in which the Corporation, LLC or other entity was created by the filing of a document with a Secretary of State or similar office under the laws of a state or Indian tribe.

- a. States refers to any state of the United States, the District of Columbia, Puerto Rico, Northern Marina Islands, American Samoa, Guam, the US Virgin Islands in any other, wealth, territory or possession of the United States.

- b. Indian tribe refers to any Indian or Alaska native tribe, band, nation, Pueblo, village or community that the Secretary of the Interior acknowledges exist as an Indian tribe. (See 25 USC 5130)

- c. In the state of Texas, the following entities generally must file or register to conduct business in the state:

A. Reporting Companies

- A domestic for-profit corporation.
- A domestic nonprofit corporation
- A domestic limited liability company (LLC)
- A domestic limited partnership (LP)
- A domestic limited liability partnership (LLP)
- A domestic professional corporation (PC)
- A domestic professional association (PA)

A. Reporting Companies

- **Note**: For incorporation purposes, a domestic for-profit corporation can be a regular Corporation or an S corporation. Under Texas law, there is no distinction at the time of registering with the Secretary State as to whether an entity is a regular Corporation or S corporation. The LP, LLP, PC, PA are referred to in the Corporate Transparency Act as other entities created by filing a document with the Secretary of State.

- d. In Texas the reference to domestic refers to an organization that was originally incorporated in Texas. Texas also allows businesses incorporated in other states to register to do business in the state. Those that are formed in another state and register here are known as foreign in nature and would include the following:
  - A foreign for-profit corporation
  - A foreign nonprofit corporation
  - A foreign limited liability company (LLC)
  - A foreign limited partnership (LP)
  - A foreign limited liability partnership (LLP)
  - A foreign professional corporation (PC)
  - A foreign professional association (PA)

A. Reporting Companies

- **Note**: For purposes of the beneficial ownership information reporting, the timeframe to report the registration of entities would be in the state of original origin not in Texas.

- Example

- ABC Inc. incorporated in Delaware on January 1, 2023. The business registered as a foreign corporation in Texas January, 1, 2024. ABC, Inc. would have until the end of 2024 to register because of the original incorporation in Delaware. They would not have 90 days from January 1, 2024 to register. The original incorporation again was in Delaware.

A. Reporting Companies

- 5. Foreign Reporting Companies. A foreign reporting company is either a corporation, LLC or other entity that was formed outside of the United States but is registered to do business in state or tribal jurisdiction within the United States. This will be evidenced by the filing of a document with the Secretary of State or similar office of the state or tribe.

- 6. Entity Created or Registered in a US Territory

- a. A company that is created or registered to do business by the filing of a document with a U.S. territory's secretary of state or similar office, and that does not qualify for any exemptions to the reporting requirements, is required to report beneficial ownership information to FinCEN. U.S. territories are the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, and the U.S. Virgin Islands.

B. Exceptions from the Reporting Requirements

B. Exceptions from the Reporting Requirements

- 1. The reporting rules do provide 23 specific types of entities that are exempt from the reporting period and that qualifies for any of these exemptions is not required to submit a report to FinCEN.

- 2. A company does not need to report to FinCEN that it is exempt from the reporting requirements if it is always been exempt.

- 3. If a company filed a report and letter qualifies for exemption, the company should file the updated report indicating that it is a newly exempt entity from the reporting requirements. For purposes of this the updated report for a newly exempt entity what only required that the unity identified itself and check the box that it’s a newly exempt entity.

- 4. The reporting company exceptions include the following:

B. Exceptions from the Reporting Requirements

- Securities reporting issuer
- Governmental authority
- Bank
- Credit union
- Depository institution holding company
- Money services business
- Broker or dealer in securities
- Securities exchange or clearing agency
- Other Exchange Act registered entity
- Investment company or investment adviser
- Venture capital fund adviser

B. Exceptions from the Reporting Requirements

- Insurance company
- State-licensed insurance producer
- Commodity Exchange Act registered entity
- Accounting firm
- Public utility
- Financial market utility
- Pooled investment vehicle
- Tax-exempt entity
- Entity assisting a tax-exempt entity
- Large operating company
- Subsidiary of certain exempt entities
- Inactive entity

B. Exceptions from the Reporting Requirements

- 5. In ascertaining whether a reporting company is exempt from reporting each one of the above requires one to two questions to be answered as documenting the exception. For example, in order for an investment company or investment advisor to be exempt the company must fit within section 3 of the Investment Company Act of 1940 and be registered with the SEC.

- **6. Broker or Dealer in Securities**. An entity that is a broker-dealer would be exempt if they follow the definition under Section 3 of the Securities Exchange Act of 1934 and is registered under Section 15 of the Securities Exchange Act of 1934.

- **7. Investment Company or Investment Advisor**. An entity here qualifies the exception if it falls within the definition of an investment company or investment advisor under Section 3 of the Investment Company Act of 1944 under Section 202 of the same act and the entity is registered with the Securities and Exchange Commission under those authorities.

B. Exceptions from the Reporting Requirements

- **8. State License Insurance Producer**. Such an entity qualifies to be exception if the entity is authorized by the state (Texas) and is subject to supervision by the insurance Commissioner or similar official or agency of the state. (Texas Insurance Board and Commission). Also, the entity has a presence at a physical office within the United States. This means they regularly conduct its business in a physical location in the United States that it owns or leases and that is physically distinct from the place of business or any other unaffiliated entity.

- **9. Commodity Exchange Act Registered Entity**. For this type of entity to be exempt they must be a registered entity as defined under the Commodity Exchange Act or they are entity registered with the Commodity Features Trading Commission.

- **10. Public Accounting Firms**. Under FinCEN, a public accounting firm qualifies for an exception if the entity is registered in accordance with Section 102 of the Sarbanes Oxley Act of 2002. (See 15 USC 7212)

B. Exceptions from the Reporting Requirements

- **11. Large Operating Company**. There are generally six requirements or criteria that must be met in order for a large operating company to be exempt from the reporting. The six criteria include the following:

- a. The entity employs more than 20 full-time employees. Full-time employees fostered the definition of a calendar month where the employee is employed an average of 30 hours per week with the employer. (See 26 CFR 54.4980 H – 1 (a) and 54.4980 H – 3)

- b. More than 20 full-time employees of the entity are employed in the United States.

- c. The entity has an operating presence at a physical office within the United States. This means that the entity rightly conducts his business in a physical location in the United States that the entity owns or leases and that is physically distant from the place of business of any other unaffiliated entity.

B. Exceptions from the Reporting Requirements

- d. The entity filed a federal income tax return or information return in the United States for the previous year demonstrating more than $5 million in gross receipts for sales. If the entity is part of an affiliated group of corporations that would include a consolidated return to meet the exception.

- e. The entity reported this greater than $5 million amount as gross receipts or sales (net of returns and allowances on Form 1120, a consolidated Form 1120, Form 1120 – S, Form 1065 or any other applicable IRS form.

- f. When gross receipts or sales from sources outside the United States, as determined under Federal income tax principle, are excluded from the entity’s amount of gross receipts or sales, the amount remains greater than $5,000,000.

- g. It should also be noted that an engaging solely in passive activities like holding rental property or and entity that is deemed unprofitable is not exempt from the reporting requirements. (See FAQ C .5)

A. Reporting Companies

- h. If the size of eight Reporting Company fluctuates above or below one of the thresholds for the large operating company exception, the reporting company will need to file a report if it meets the definition of a reporting company and does not meet the criteria for the large operating company exception or any other exception.

- i. If the company files a report and then becomes exempt as a large operating company the company should file a newly exempt entity report noting that they are now exempt.

- j. If at a later date, the company no longer meets the criteria for the large operating company exception, the reporting company should file an updated report. Updated reports are filed in 30 days.

A. Reporting Companies

- k. The Corporate Transparency Act (CTA) specifies that a company may qualify for the large operating company exemption based on a Federal income tax or information return filed “in” the previous year, while FinCEN’s regulations refer to tax or information returns filed “for” the previous year.

- (i) To the extent a tax or information return for the previous year was not filed in the previous year (e.g., because a company has not filed its return for the previous year at the time beneficial ownership information is required to be reported, or because the return filed in the previous year was for a prior year), a company should use the return filed in the previous year for purposes of determining its qualification for the exemption.

A. Timeline for Reporting

- (ii) If a company relying on this exemption subsequently files a tax return demonstrating less than $5 million in gross sales or receipts, and it no longer qualifies for the large operating company exemption or any other exemption, it has 30 days from the date of the tax return to file an initial BOI report.

- (iii) The Federal income tax or information return must demonstrate more than $5,000,000 in gross receipts or sales, as reported as gross receipts or sales (net of returns and allowances) on the entity's IRS Form 1120, consolidated IRS Form 1120, IRS Form 1120-S, IRS Form 1065, or other applicable IRS form, excluding gross receipts or sales from sources outside the United States, as determined under Federal income tax principles.

A. Timeline for Reporting

- **12. Tax Exempt Entity**. A tax-exempt entity qualifies for exception if any of the following four criteria apply:
- a. The entity is an organization that is described in section 501(c) of the Internal Revenue Code of 1986 (
- (determined without regard to section 508(a) of the Code)and exempt from tax under section 501(a) of the Code.
- b. The entity is an organization that is described in section 501(c) of the Code, and was exempt from tax under section 501(a) of the Code, but lost its tax-exempt status less than 180 days ago.
- c. The entity is a political organization, as defined in section 527(e)(1) of the Code, that is exempt from tax under section 527(a) of the Code.
- d. The entity is a trust described in paragraph (1) or (2) of section 4947(a) of the Code.

A. Timeline for Reporting

- **13. Entity Assisting a Tax Exempt Entity**. An entity qualifies for this exception if all four of the following apply:

- a. The entity operates exclusively to provide financial assistance to, or hold governance rights over, any tax-exempt entity described under the Tax Exempt Entity Provision above.

- b. The entity is a United States person as defined in section 7701(a)(30) of the Internal Revenue Code of 1986

- c. The entity is beneficially owned or controlled exclusively by one or more United States persons that are United States citizens or lawfully admitted for permanent residence. “Lawfully admitted for permanent residence” is defined in section 101(a) of the Immigration and Nationality Act (8 U.S.C. 1101(a)).

- d. The entity derives at least a majority of its funding or revenue from one or more United States persons that are United States citizens or lawfully admitted for permanent residence.

A. Timeline for Reporting

- **14. Subsidiary of Certain Exempt Entities**. The entity qualifies for this exception if the entity’s ownership interests are controlled or wholly owned, directly or indirectly, by any of these types of exempt entities:

A. Timeline for Reporting

- Securities reporting issuer
- Governmental authority
- Bank,
- Credit union
- Depository institution holding company
- Broker or dealer in securities
- Securities exchange or clearing agency
- Other Exchange Act registered entity
- Investment company or investment adviser
- Venture capital fund adviser
- Insurance company
- State-licensed insurance producer
- Commodity Exchange Act registered entity
- Accounting firm
- Public utility
- Financial market utility
- Tax-exempt entity; or
- Large operating company

A. Timeline for Reporting

- a. If an exempt entity controls some but not all of the ownership interests of the subsidiary, the subsidiary does not qualify. To qualify, a subsidiary’s ownership interests must be fully, 100 percent owned or controlled by an exempt entity.

- b. A subsidiary whose ownership interests are controlled or wholly owned, directly or indirectly, by certain exempt entities is exempt from the BOI reporting requirements. In this context, control of ownership interests means that the exempt entity entirely controls all of the ownership interests in the reporting company, in the same way that an exempt entity must wholly own all of a subsidiary’s ownership interests for the exemption to apply.

A. Timeline for Reporting

- **15. Inactive Entity**. An entity qualify for this exception if all six of the following criteria apply:

- a. The entity was in existence on or before January 1, 2020.

- b. The entity is not engaged in active business.

- **Note:** This does not relate to a passive entity this means there is zero income activity.

A. Timeline for Reporting

- c. The entity is not owned by a foreign person, whether directly or indirectly, wholly or partially. “Foreign person” means a person who is not a United States person. A United States person is defined in section 7701(a)(30) of the Internal Revenue Code of 1986 as a citizen or resident of the United States, domestic partnership and corporation, and other estates and trusts.

- d. The entity has not experienced any change in ownership in the preceding twelve-month period.

- e. The entity has not sent or received any funds in an amount greater than $1,000, either directly or through any financial account in which the entity or any affiliate of the entity had an interest, in the preceding twelve-month period.

- f. The entity does not otherwise hold any kind or type of assets, whether in the United States or abroad, including any ownership interest in any corporation, limited liability company, or other similar entity.

A. Timeline for Reporting

- **16. Public Utility**. The exemption from reporting regarding public utilities is pursuant to 26 USC 7701 (a) (33) (A). This provides that telecommunication services, electrical power, natural gas, water and sewer services within the United States are not required to report its beneficial ownership information. The exemption includes a corporation engaged in the furnishing or sale of telephone or telegraph services if the rates for such furnishings or sales meets the requirements of 26 USC 7701 (a) (33) (A).

- **17. Pooled Investment Vehicle**. This entity qualifies for exception if it is an investment company as defined under Section 3 (a) of the Investment Company Act of 1940 or is a company that would be an investment company under that section but for the exclusion provided from that definition and is identified by its legal name by the applicable investment advisor or successor advisor with the Securities and Exchange Commission. In addition the entity's operator advised by other types of exempt entities which would include a bank, credit union, broker-dealer and securities, investment company or investment advisor, venture capital fund advisor.

A. Timeline for Reporting

- 18. FinCEN has published on its website a document titled Beneficial Ownership Information Reported Requirements: Small Entity Compliance Guide that lists the criteria for exception for the other entities listed herein that were not covered in this outline.

C. Statutory Trusts, Business Trusts Foundations

- 1. Whether or not statutory trusts, business trust or foundations are Reporting companies depends on the formation. For example, a statutory trust, business trust or foundation would be a reporting company if it was created by the filing of a document with a Secretary of State person or office. Similarly, a foreign entity is a reporting company only if it filed a document with the Secretary of State for summer office to register to do business in the United States.

- a. Obviously, state laws vary on whether trusts are required to have the filing of a document with the Secretary of State for similar office to be created or registered. If a trust is created in the US jurisdiction that requires the state filing that is a reporting company unless one of the prior exemptions applied.

C. Statutory Trusts, Business Trusts Foundations

- 2. It should be noted the registration of a trust with a court of law merely to establish the course jurisdiction over any disputes involving the trust does not make the trust a reporting company.

- **3. FinCEN Proposal for Nonfinancial Purchases of Residential Real Estate and Gratuitous Transfers**

C. Statutory Trusts, Business Trusts Foundations

- a. On February 7, 2024, FinCEN issued a notice of proposed rulemaking proposing a nationwide reporting obligation on settlement agents, title insurance agents, escrow agents and attorneys to identify and report the individual beneficial owners of specified entities and trusts requiring residential real estate through “all cash” purchases or gratuitous transfers to trust within 30 calendar days after the date of closing. The purpose of the initiative is to combat anonymous laundering of proceeds through the purchase of residential real estate.

- b. Reportable transfers would include “all cash “and nonfinancial institution finance purchases with no dollar threshold as well as transfers of ownership at no value. This would include gifts of an ownership interest in residential real property to a trust. The transfer of which involves a reporting person excluding transfers between individuals. Ownership would be evidenced by deed, stock share, membership, certificate or other contractual agreement evidencing ownership.

C. Statutory Trusts, Business Trusts Foundations

- c. A transfer of ownership interest encompasses sales as well as nonsale transfers. Nonsale transfers would include gifts and transfers to trust. The only exception presently would be a transfer by death. Also, there is no dollar threshold or exceptions for transfers above or below a set value.

- d. Groups that would be exempt from reporting include government authorities, insurance companies, banks, Federal credit unions. Nonprofit organizations would not be exempt.

- e. The proposed regulation would accept the following transfers:
  - An extension of credit secured by the real property
  - A revocation, transfer or granting of an easement
  - A transfer incident to a divorce
  - A bankruptcy

C. Statutory Trusts, Business Trusts Foundations

- f. The reporting person or person obligated to report would be settlement agents, title insurance agents, escrow agents and attorneys.

- g. The primary information that is reportable relates to beneficial owners of a transferee trust or transferee entity acquiring the real estate. Beneficial owners under this approach could include the following:

C. Statutory Trusts, Business Trusts Foundations

- The beneficial owners who are individuals who would be the beneficial owners of a transferee entity on the date of closing. In essence these are individuals who directly or indirectly exercise substantial control over a transferee entity or owner control at least 25% of the interest of a transferee entity
  - A beneficial owner who is a trustee of a trust
  - A beneficial owner who is an individual other than a trustee with authority to dispose of transferee trust assets – power of attorney
  - A beneficiary who is the sole recipient of income and principal from the trust or who has the right to demand a distribution of or withdraw substantially all the assets from the trust
  - A grantor or settler who has the right to revoke the transferee trust or withdraw the assets of the trust
  - A beneficial owner of any legal entity or trust that holds one of the above positions.

C. Statutory Trusts, Business Trusts Foundations

- h. The proposal would not require reporting persons to report changes to beneficial ownership of an entity or trust on an ongoing basis. The reporting would be through the FinCEN website. The reporting will be no later than 30 calendar days after the closing occurs.

- i. The proposed date of enactment will be one year from the date the final realization. The matter is under commentary at the present time.

D. Sole Proprietorships and General Partnerships

- 1. Unless the sole proprietorship was created in the United States by filing a document with the Secretary of State for similar office is there is no reporting requirement.

- 2. Filing a document with a government agency to obtain either:
  - a IRS employer identification number,
  - a fictitious business name, or
  - a professional or occupational license does not create a new entity, and therefore does not make a sole proprietorship filing such a document a reporting company.

D. Sole Proprietorships and General Partnerships

- 2. Disregarded entities that would file a Schedule C may have a reporting requirement. This is particularly the case if the disregarded entity is incorporated in the state through the office of the Secretary of State.

- 3. General Partnerships

- a. Under the Texas Business Organization Code, a general partnership is not required to register with the Texas Secretary of State. The federal legislation under the Corporate Transparency Act is silent on this. It thus appears that general partnerships formed in the state are not required to submit a filing of a beneficial ownership information report.

D. Sole Proprietorships and General Partnerships

- 4. Assumed Names

- a. The Beneficial Ownership Information report does have an inquiry as to whether an entity has an assumed name. Under Texas law, an assumed name can be registered with the Texas Secretary of State.

- b. The Assumed Name Registered with the Texas Secretary of State can be done for all counties or specific counties.

D. Sole Proprietorships and General Partnerships

- c. If it is a business entity that is registered previously with the Texas Secretary of State, the assumed name would be reported along with the business entity under the beneficial ownership information reporting rules specified in the Corporate Transparency Act.

- d. If the assumed name is associated with a sole proprietorship, it cannot be registered with the Texas Secretary of State and as such does not create a reporting requirement to FinCEN. This also appears to be the case with a general partnership.

D. Sole Proprietorships and General Partnerships

- 5. Disregarded Entities

- a. Recently FinCEN issued a revised FAQ on disregarded entities. They indicated that these entities must still report if they meet the definition of a reporting company.

D. Sole Proprietorships and General Partnerships

- b. Disregarded entities may report using different types of tax identification numbers such as EIN, Social Security or an Individual Tax Identification Number.

- c. FinCEN used this FAQ to strongly indicate that all reporting companies must have a tax identification number in order to submit the report.

E. S Corporations

- 1. A corporation treated as a pass-through entity under Subchapter S of the Internal Revenue Code (an “S Corporation” or “S-Corp”) that qualifies as a reporting company—i.e., that is created or registered to do business by the filing of a document with a secretary of state or similar office, and does not qualify for any of the exemptions to the reporting requirements—must comply with the reporting requirements.

- 2. The S-Corp’s pass-through structure for tax purposes does not affect its BOI reporting obligations. In particular, pass-through treatment under Subchapter S does not qualify an S-Corp as a “tax-exempt entity” under FinCEN BOI reporting regulations.

F. Homeowners Associations (HOA)

- 1. These entities may be a Reporting Company. The determination is based on how the HOA was formed.
- 2. If an HOA was not created by the filing of a document with a secretary of state or similar office, then it is not a domestic reporting company.
- 3. An incorporated HOA or other HOA that was created by such a filing also may qualify for an exemption from the reporting requirements. For example, HOAs recognized by the IRS as section 501(c)(4) social welfare organizations may qualify for the tax-exempt entity exemption.
- 4. An incorporated HOA that is not a section 501(c)(4) organization, however, may fall within the reporting company definition and therefore be required to report BOI to FinCEN.

IV. Beneficial Owner of Company

A. General

- 1. If your company or your client's company is reporting company, the next thing that must be determined is to identify the beneficial owners.
- 2. Beneficial owners are any individual who, directly or indirectly:
  - Exercise a substantial control over a reporting company; or
  - Owns or controls leased 25% of the ownership interest of a reporting company.
- 3. Beneficial owners must be individuals (i.e., natural persons).
- a. Trusts, corporations, or other legal entities are not considered to be beneficial owners. However, in specific circumstances, information about an entity may be reported in lieu of information about a beneficial owner.
- 4. A reporting company can have multiple beneficial owners. There is no maximum number of beneficial owners who must be reported.

Example

- ABC Company is a Reporting Company that has one beneficial owner who exercises substantial control over the company and five other beneficial owners who all own or control 25% of the ownership interest of the reporting company.

- a. According to FinCEN, it expects that every reporting company will be substantially controlled by one or more individuals, and therefore that every reporting company will be able to identify and report at least one beneficial owner to FinCEN. (FAQ D .1)

B. Exceptions from Determination of Beneficial Owner

- 1. There are five exceptions associated with not be deemed a beneficial owner. If the party falls within these five exceptions the reporting company does not have to report the individual as a beneficial owner to FinCEN. The exceptions are as follows:

- **a. A Minor Child**. This involves an individual defined under the laws of the state in which the best the company is created or the foreign company is first registered.

- (i) However, the minor child may be exempt but the parent or legal guardian of the minor child may become the beneficial owner and required to be reported. Under FinCEN, the minor child exception only applies to the parent or legal guardians information is reported in lieu of the minor child.

B. Exceptions from Determination of Beneficial Owner

- (ii) Under Texas Family Code Section 3.103, except as provided, during the marriage of the parents of an unemancipated minor for home and managing conservator has not been imported, the earnings of the minor are subject to the joint management, control and disposition of the parents of the minor, unless otherwise provided by agreement of the parents or by judicial order. Judicial order could include a guardian. As such, the Texas statutory provision would require the parent or the guardian to be the reporting beneficial owner.

- (iii) When the minor child reaches age of majority as defined by state law or Indian tribe in which the reporting chummy was created her first registered the exception no longer applies. At that time, the individual is a beneficial owner and the reporting company must file an updated report.

B. Exceptions from Determination of Beneficial Owner

- b. Nominee, Intermediary, Custodian or Agent. Individual qualifies for this exception if the individual is merely acting on behalf of an actual beneficial owner as the beneficial owners nominee, intermediary, custodian or agent.

Example

- John, performs advisory or contractual services as a tax professional to Bubba. John is not a beneficial owner and no reporting is required. However, Bubba is the beneficial owner and must report.

B. Exceptions from Determination of Beneficial Owner

- i. Partnership Representative or Tax Matters Partner. Whether or not the partner representative or tax matters partner Form 1065 is a beneficial owner is a fact and circumstance examination. An individual may qualify as a beneficial owner of the reporting company if the individual exercises substantial control over the reporting company, or owns or controls at least 25 percent of the company's ownership interests. (See FAQ D .10)

- c. An Employee. An employee of Reporting Company may be exempt if the following three criteria apply:

B. Exceptions from Determination of Beneficial Owner

- (i) The individual is an employee of the reporting company, when applying the meaning of “employee” provided in 26 CFR 54.4980H-1(a)(15). In general, the term employee means that an individual is subject to the will and control of the employer in what and how to do work, and that the employer may discharge the individual from work.

- (ii). The individual’s substantial control over, or economic benefits from, the reporting company are derived solely from the employment status of the individual as an employee.

- (iii). The individual is not a senior officer of the reporting company. The term “senior officer” means any individual holding the position or exercising the authority of a president, chief financial officer, general counsel, chief executive officer, or chief operating officer, or any other officer, regardless of official title, who performs a similar function.

B. Exceptions from Determination of Beneficial Owner

- d. An Inheritor. This pertains to individual whose only interest in reporting company is a future interest through our right of inheritance, through a will that would provide a future interest in the company. Once the individual inherits the interest, this exception no longer applies, and the individual may qualify as a beneficial owner.

- e. A Creditor. The individual is a creditor of the reporting company. The term “creditor” means an individual who would meet the definition of a beneficial owner of the reporting company solely through rights or interests for the payment of a predetermined sum of money, such as a debt incurred by the reporting company, or a loan covenant or other similar right associated with such right to receive payment that is intended to secure the right to receive payment or enhance the likelihood of repayment.

Example

- Bubba has lent ABC Company, a reporting company $10,000 and has executed an appropriate security interest and promissory note. Bubba is exempt from reporting. Now assume Bubba loans ABC Company $ 10,000 in his capacity as a shareholder (loan from shareholder). Bunna is not exempt from reporting as a beneficial owner because he has equity in the company.

B. Exceptions from Determination of Beneficial Owner

- **2. CPAs or Attorneys**. CPAs and attorneys generally do not qualify as beneficial owners. However, that may be depending upon the type of work being performed. CPAs and attorneys who provide general accounting or legal services are not considered beneficial owners because ordinary, arms-length advisory or other third-party professional services to a reporting company are not considered to be in substantial control. An attorney or CPA who is designated as an agent of the reporting company may qualify for the nominee, intermediary, custodian or agent exception from the beneficial ownership definition.

- **a. Note**: An individual who holds the position of general counsel in a reporting company is a “senior officer” of that company and is therefore a beneficial owner.

B. Exceptions from Determination of Beneficial Owner

- **3. Management Company Providing Services to Reporting Company**

- a. An unaffiliated company such as a management company to be a beneficial owner of the reporting company because a beneficial owner must be an individual.

C. Substantial Control Defined

- 1. Reporting Companies are required to identify all individuals who exercise substantial control over the company. There is no limit to the number of individuals who can be reported for exercising substantial control.

- 2. An individual exercises substantial control over a Reported Company of an individual beats any of the following four criteria:
  - the individual is a senior officer;
  - the individual has authority to appoint or remove certain officers or a majority of directors of
  - the reporting company;
  - the individual is an important decision-maker; or
  - the individual has any other form of substantial control over the reporting company.

C. Substantial Control Defined

- 3. Senior Officer Defined. This is an individual holding the position exercising authority as President, Chief Financial Officer, General Counsel, Chief Executive officer, Chief Operating officer or any other officer, regardless of official time to, who performs a similar function as these officers.

- 4. Appointment for Removal Authority. This pertains to an individual with the ability to appoint or remove any senior officer or majority of the board or similar body.

- 5. Definition of Important Decision – Maker. This is an individual who directs, determines or substantial influence over important decisions made by the reporting company including decisions regarding the following:

C. Substantial Control Defined

- Business Operations. This includes, but is not limited, to:
  - Nature, scope and attributes the business.
  - The selection or termination of a business lighter ventures or geographic focus.
  - The entry into our termination or fulfillment are nonfulfillment of significant contracts.

- Financial Operations. This includes, but is not limited, to:
  - Sales, leases, mortgages or other transactions of any principal assets.
  - Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget.
  - Compensation schemes and incentive programs for senior officers.

- Structural Operations. This includes, but is not limited, to:
  - Reorganizations, dissolutions, mergers and acquisitions.
  - Amendments of any substantial governance documents of the reporting company, included the articles of incorporation or similar formation documents, bylaws or certificate policies or procedures.

C. Substantial Control Defined

- **6. Other Forms of Substantial Control Exercise**. This would involve the exercises substantial control in a new or unique way that would be deemed substantial.

- 7. The determination of substantial control is done on both of direct and indirect basis. An individual may directly or indirectly, including as a trustee of a trust or similar arrangement, exercise substantial control over a reporting company through:

C. Substantial Control Defined

– Board representation;
– Ownership or control of a majority of the voting power or voting rights of the reporting company;
– Rights associated with any financing arrangement or interest in a company;
– Control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;
– Arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or
– any other contract, arrangement, understanding, relationship, or otherwise.

Examples of Substantial Control on a Direct Basis

- Substantial Control on a direct basis can be determined by ascertaining if an individual exercises such through contracts, arrangements, understandings, relationships or otherwise. This could include board representation of the Reporting company.

- A board member is not always a beneficial owner of a reporting company unless they own or control at least 25% of the ownership interest of the reporting company. (FAQ D .9)

Examples of Substantial Control on Indirect Basis

- Substantial Control on indirect basis over a reporting company could be determined by examining control of one or more intermediaries entities that separately or collectively exercise substantial control over the reporting entity. Intercompany loans, shareholder loans would also fall within the category. Likewise, a trustee of a trust may exercise substantial control over reporting entity in the trust and the trustee would have a required reporting requirement.

B. Exceptions from Determination of Beneficial Owner

- 8. Director of a Board

B. Exceptions from Determination of Beneficial Owner

- a. Under FAQ D .9, a board member is not always a beneficial owner of a reporting company unless they own or control at least 25% of the ownership interest of the reporting company.

- b. Nonetheless, a board member may still be a beneficial owner if they exercise substantial control. The determination of this would likely be based on governance documents such as the bylaws.

- c. Specifically, the termination would have to be made as to whether the board of directors has one or more individuals possessing the power ability to remove a majority of the board or body. Questions to look at would include the following:

B. Exceptions from Determination of Beneficial Owner

- Does your company have a Board of Directors or similar body and do they have an individual with the ability to appoint or remove a majority of the board or body?
- Does any individual have the ability to appoint or remove a senior officer of your Company?
- Does any individual direct, determine or have substantial influence over important decisions made by your company including decisions regarding the company's business, finances or structure?
- Other individuals who have substantial control of your company in ways other than those identified above?(See Small Entity Compliance Guide, December 2023 – Version 1.1)

B. Exceptions from Determination of Beneficial Owner

- d. It is conceivable that one or more members of a Board of Directors would be a beneficial owner because of the ability to assert substantial control. The questions above infer not just a current power or duty but a potential power or duty.

- e. It is conceivable that you may have a board member that is a beneficial owner with no ownership of stock but has the ability to assert substantial control through policies, procedures and governance documents. The facts of decision-making may be government collective basis does not appear to matter in terms of reporting to FinCEN.

B. Exceptions from Determination of Beneficial Owner

- **9. Voting Agreements**

- a. The parties to a voting agreement agree to vote as a block on specific matters spelled out in the agreement. Whether the parties to the agreement can exert substantial influence depends on the specific matters and their combined voting power. It’s safe to assume that matters important enough to be the subject of a voting agreement involve significant governance and control issues. However, a reporting company can only be responsible for considering the impact of a voting agreement if it is aware of the agreement’s existence.

B. Exceptions from Determination of Beneficial Owner

- b. When the parties to the agreement represent 25% or more of the voting power, it should be safe to assume they are able to exert substantial control. If the parties together hold less than 25% of the voting power, then the presence of other persons holding substantial voting power would be a factor in the assessment.

- c. A voting agreement may include a covenant that certain parties have the right to nominate a representative to the board of directors, and then all of the parties will vote in favor of all of the designated nominees. This isn't a contractual right to board representation per se, but if it assures that the parties' designees will be elected, then it should be sufficient to represent substantial influence.

B. Exceptions from Determination of Beneficial Owner

- d. But what if the voting arrangement substantially increases the likelihood of the parties' designees being elected? For example, if the two parties to a voting agreement exercise 40% of the voting power, they would start with a substantial advantage toward securing two positions on the board of directors.

- e. The determination of substantial control is not solely based upon voting power. Substantial control can also involve allocating control the business beyond voting power triggering a disclosure requirement. As previously indicated the issue substantial control will only be of concern to businesses that do not qualify for reporting exception. For example, a startup company could receive multiple rounds of investment but not yet obtained the annual gross revenue threshold to be exempt as a large operating company.

B. Exceptions from Determination of Beneficial Owner

- f. The business may operate through multi-entity structures in which a parent and some subsidiaries do not have 20 full-time employees. Entity’s funding operations with capital contributed by investors who obtain governance rights in their investment agreements may have to evaluate those could be a reporting requirement.

- **10. Assessing Substantial Control Beyond Voting Powers**

B. Exceptions from Determination of Beneficial Owner

- **a. An Investor Negotiates and Obtains Contractual Rights to Designate A Director**. This would constitute asserting significant control and influence and would likely be identified as a beneficial owner. Likewise a beneficial owner could be in play if an investor were to demand contractual observer rights instead of the right to appoint a director.

- **b. Consent Rights**. If reporting company enters into an agreement with an investor that grants the investor the right to consent to one or more transaction specified in the governance documents, it would be reasonable to conclude that that individual is exerting substantial influence in a reporting would be required.

B. Exceptions from Determination of Beneficial Owner

- **c. Distribution Rights and Priority**. When a company has received one or more rounds of outside investment, the priority in which investors receive distributions in the amount they receive generally is negotiating the investor sets that forth in governing documents. As such, distributions will all be made with the company generating cash flow beyond what is required for operations. The regulations do not expressly classify decisions on the timing and amount of distributions as important decisions but it could be in some instances particularly if it is left up to the Board of Directors, in senior management.

- **d. Rights of First Refusal**. While there may be an argument that there is no substantial control, generally these rights result in a shareholder desiring to exit having their stock, capital property interest going back to one or more of the other owners which could exceed the 25% threshold. With the unintended consequence of a beneficial owner that did not have to report now having to report.

B. Exceptions from Determination of Beneficial Owner

- **e. Right of First Offer**. Again, this could be both an exercise of substantial control and increasing ownership threshold over 25% requirement where an existing shareholder owner must offer their interest to the company and other owners before offering it to outside third parties.

- **f. Drag Along Rights**. These are generally associated with a sale of the company. The right grants the owner or group of owners holding a majority of the interest in the reporting company the ability to sell all of the interest to a third party the right to force the other owners to sell their interest to the third party. The right facilitates sale by allowing the acquirer to avoid inheriting minority owners who have rights to acquire but must honor those in terms of the buyout.

B. Exceptions from Determination of Beneficial Owner

- 11. Uncertainty. During the solicitation of comments on Substantial Control, FinCEN acknowledge that many commentators indicated that substantial control was too broad, overinclusive and vague. The definition did not change so there still remains uncertainty over who qualifies as having substantial control. FinCEN repeatedly has indicated that the definition requires the identification of key individuals who stand behind the reporting company and directs its actions. No further guidance on this has occurred.

D. Ownership Interest Defined

- 1. An ownership interest is generally an arrangement that establishes ownership rights in the reporting company. Examples of ownership interests include shares of equity, stock, voting rights, or any other mechanism used to establish ownership.

- 2. Reporting companies are required to identify all individuals who own or control at least 25 percent of the ownership interests of the company.

- 3. The following may be viewed as ownership interest being on a direct or indirect basis:

- a. Equity Stock or Voting Rights. This pertains to any interest classified as stock or anything similar regardless of whether it confers voting power or voting rights even if the interest is transferable. This appears to into three broad categories
  - Equity, stock or similar interest
  - Pre-organization certificate or subscription
  - Transferable share of, or voting trust certificate or certificate of deposit for an equity security interest in a joint venture or certificate of interest in a business trust

D. Ownership Interest Defined

- b. Capital or Profit Interest. This would include any interest in the assets or profits of the company organized as an LLC which is similar to stock in a corporation is sometimes referred to as units. It appears there were also include the capital account associated with a limited partnership.

- c. Convertible Instruments. This would include instruments that are convertible to equity, stock, voting rights or capital or profit interest whether or not anything would need to be paid to exercise the conversion. This could also include the following:
  - Ownership interest associated with any future on any convertible instrument,
  - Any warrants or right to purchase, sell or subscribe to a share or interest in equity, stock, voting rights or capital or profit even if the warrant or right is a debt instrument. (Conversions of debt-to-equity)

D. Ownership Interest Defined

- d. Options are Non-binding Privileges to Buy or Sell. This refers to puts, calls, straddles or other option or privilege of buying or selling equity, stocks, voting rights, capital interest, profit interest or convertible instruments. However this would not include an option or privilege created and held by others without the knowledge or involvement of the Reporting Company.

- e. Other Instruments, contracts or Mechanisms Used to Establish Ownership. Restricted stock units would fall in this category.

D. Ownership Interest Defined

- 4. Direct Ownership. This could include joint ownership with one or more persons of an undivided interest.

- a. 31 CFR 1010.380 (d) (ii) (A) states that an individual may directly or indirectly own or control and ownership interest of a reporting company through any contract, arrangement, understanding, relationship or otherwise including joint ownership with one or more persons of an undivided interest in such interest

- b. Community Property. The rules are silent on joint ownership associated with community property. The Corporate Transparency Did not provide a definition of joint ownership but did include the phrase joint ownership in terms of ascertaining direct ownership. Under the laws of the state of Texas,, Texas Family Code 3.002 identifies community property as:

D. Ownership Interest Defined

- Consisting of the property, other than separate property acquired by either spouse during the marriage.

- (i) Likewise, Texas Family Code Section 3.003 states that property possessed by either spouse during her on the dissolution of marriage is presumed to be community property.

- (ii) Under Texas Family Code Section 3.101, each spouse has the sole management, control and disposition of that spouse's separate property. However, under Texas Family Code Section 3.102, during marriage, each spouse is the sole management, control and disposition of the community property that the spouse would have owned if single including personal earnings, revenue from separate property, recovery for personal injuries and the increase in mutation, and the revenue from, all property subject to the spouse's sole management, control and disposition.

D. Ownership Interest Defined

- (iii) Under Texas Family Code Section 3.102 (b), if community property subject to the sole management, control and disposition of one spouse is mixed or combined with the community property subject to the sole management, control and disposition of the other spouse, then mixed or combined community property is subject to the joint management, control and disposition of the spouse's, list the spouses provide otherwise by power of attorney in writing or other agreement.

- (iv) Finally, under Texas Family Code Section 3.102 (e), community property is such a joint management, control and disposition of the spouses unless the spouses provide otherwise by power of attorney in writing or other agreement.

- (v) Note: It appears based upon the community property rules of Texas that in ascertaining either substantial control or the 25% ownership interest test, reporting companies may have to include both spouses if either would be a beneficial owner and if that spouse is married and resides in a community property state such as Texas. It does not appear that the community property laws do not exclude the ownership interest from the community property of the marriage.

Examples

- Bubba and Bubbet are married and they live in Texas which is a community property state. Bubba is the CEO of ABC, Inc. his wife works for the same company but she is a secretary. The wife would not be reported as a beneficial owner but Bubba would be because he is a senior officer.

- Bubba and Bubbet are married and they live in Texas which is a community property state. Bubba is the CEO of ABC, Inc. a C Corporation he formed during the marriage. Bubbet is not a stockholder nor is an officer in the company. Bubba owns 100% of the stock. Bubbet is not exercising substantial control. However, from a committee property perspective she may be a beneficial owner on an indirect basis because of the committee property rights to at least 50%. Are we having fun yet?

Examples

- Bubba and Bubbet are married and lived in Texas in a community property state. Bubba is a senior vice president of ABC, Inc. and LLC of which he owns 40%. He received the 40% during the marriage. He would be a beneficial owner because he’s a senior vice president. If Bubbet has no affiliation with the company she is not a beneficial owner.

- Assume Bubba owns 40% of ABC LLC. ABC LLC is a partnership in the 40% represents capital and profit ownership. Bubba is passive he is a member only. The LLC operates via managers. Bubba would not be exerting substantial control but arguably would have a reporting requirement because he’s over the 25% ownership threshold.

- Now assuming that he received the 40% during the marriage to Bubbet. Bubba has no affiliation with the LLC. The receipt is in a community property state such as Texas. Again, both do not exercise substantial control. The argument could be made that they are below the ownership threshold of 25% because it is community property.

D. Ownership Interest Defined

- 5. Indirect Ownership. This can include owning or controlling one or more intermediaries entities or the ownership of interests of an intermediary entity that separately or collectively owns or controls ownership of the reporting entity.

- a. Indirect ownership can also occur through an individual acting as a nominee, intermediary, custodian or agent. The actual nominee, intermediary, custodian or agent is not a beneficial owner because they are not asserting either substantial control or possess the ownership interest. (See Small Entity Compliance Guide, December 2023 – Version 1.1)

D. Ownership Interest Defined

- b. IRS Regulation 1.414 (c) – 4; Rules for Determining Ownership. Under the constructive ownership rules clients may also wish to look at 1.414 (c) – 4 (5) with respect to constructive ownership on spouses. This section states that an individual shall be considered on an interest, directly or indirectly, by or for his or her spouse, other than a spouse was legally separate from the individual under a decree of divorce, whether in a laboratory or final or decree of separate maintenance.

- Note: With the exception of a spouse in community property state, the Corporate Transparency Act does not factor in related parties in terms of the substantial control or ownership test on indirect basis.

Example

- John owns 80% of XYZ Company. XYZ Company owns 30% of ABC Company. John is treated as owning 24% of ABC (80% of XYZ x 30%) this is important in that John would not have a reporting requirement with respect to ABC because he is under the 25% ownership threshold but would have a reporting requirement because he directly owns 80% of XYZ Company.

- **Note:** The other attribute would be an individual is considered owning stock that is owned via family members that are related as described herein.

Example

- Bob owns 30% in ABC, Inc. His wife owns 20%, his grandson owns 5% and his nephew owns 15%. Bob would be a beneficial owner based upon owning more than 25%. His wife, grandson and nephew, despite the constructive ownership rules would not have a beneficial ownership reporting requirement based solely upon the ownership test. It is conceivable that they might if there was an assertion or documentation showing they exerted substantial control.

D. Ownership Interest Defined

- 1. If ownership of a reporting company is the subject of active litigation and an initial BOI report has not been filed, a person authorized by the company to file its beneficial ownership information should comply with the requirements by reporting:
  - all individuals who exercise substantial control over the company, and
  - all individuals who own or control, or have a claim to ownership or control of, at least 25 percent ownership interests in the company.

- 2. If an initial BOI report has been filed, and if the resolution of the litigation leads to the reporting company having different beneficial owners from those reported (for example, because some individuals' claims to ownership or control have been rejected), the reporting company must file an updated BOI report within 30 calendar days of resolution of the litigation. (See FAQ D .11)

D. Ownership Interest Defined

- 3. Restrictive Transfer Agreements can trigger an ownership issue if they are in the event exercised. Often times the restriction is associated with an existing owner having to sell their interest back to the reporting company or existing owners.

- a. The existing owners may have not been beneficial owners previously may become beneficial owners as a result of the exercise of the restriction. Such rights could include those that were previously discussed.

- b. They can also include rights to maintain one’s ownership interest whereby individual owners have the right to buy a pro rata portion of any future offerings by the company to purchase its ownership interest. The desire is to prevent the company from issuing additional interest in diluting the ownership interest or reducing the percentage interest of the owners.

F. Homeowners Association

- 1. A homeowners association (HOA) that meets the reporting company definition and does not qualify for any exemptions must report its beneficial owner(s). A beneficial owner is any individual who, directly or indirectly, exercises substantial control over a reporting company, or owns or controls at least 25 percent of the ownership interests of a reporting company.

- 2. There may be instances in which no individuals own or control at least 25 percent of the ownership interests of an HOA that is a reporting company. However, FinCEN expects that at least one individual exercises substantial control over each reporting company.

- 3. Individuals who meet one of the following criteria are considered to exercise substantial control over the HOA:
  - the individual is a senior officer;
  - the individual has authority to appoint or remove certain officers or a majority of directors of the HOA;
  - the individual is an important decision-maker; or
  - the individual has any other form of substantial control over the HOA.

G. Trusts

- 1. A beneficial owner can all control reporting company through a trust.
- 2. This can be achieved by either exercising substantial control over reporting company through a trust agreement or by owning or controlling the ownership interest of a reporting company that is held in a trust. This begs the question as to who are the reporting company's beneficial owners with individuals own or control the company through a trust.
- 3. The determination of the beneficial owner is based on the same test previously discussed that of exercising substantial control over the reporting entity or owning or controlling at least 25% of the reporting company's ownership interest. The trust agreement would have to be examined under these conditions. In essence, it is a facts and circumstance examination.

G. Trusts

- 4. A trustee may be a beneficial owner of a reporting company either by exercising substantial control over the reporting company, or by owning or controlling at least 25 percent of the ownership interests in that company through a trust or similar arrangement. Certain beneficiaries and grantors or settlors may also own or control ownership interests in a reporting company through a trust.

- 5. The following conditions indicate that an individual owns or controls ownership interests in a reporting company through a trust:
  - a trustee (or any other individual) has the authority to dispose of trust assets;
  - a beneficiary is the sole permissible recipient of income and principal from the trust, or has the right to demand a distribution of or withdraw substantially all of the assets from the trust; or
  - a grantor or settlor has the right to revoke the trust or otherwise withdraw the assets of the trust.

G. Trusts

- **Note:** This is not an exhaustive list of conditions under which an individual owns or controls ownership interest in reporting unity through a trust. In essence, facts and circumstances may dictate a reporting requirement.

Examples

- John owns 50% of ABC, Inc. stock and the John Family Trust owns the other 50%. Jane is the trustee of the trust. The trust agreement gives her the power and authority to dispose of trust assets. Similar to is a beneficiary of the trust with a right to demand a distribution from the trust. Jane, as trustee exerts substantial control over ABC, because of the trust powers. She is presumed to hold indirect ownership interest because of her position as trustee. Her indirect ownership interest is 50%. She is both the beneficial owner because of the powers and duties of the trustee (substantial control) and the indirect ownership of the trust in relation to the reporting Company, ABC,. Sue is a beneficiary does not have substantial control over the reporting company. However, she's present dollars ownership interest on indirect basis over the reporting company. The reason is she has a right to demand distributions from the trust. The key here is a right to demand. So in the end John, Jane and Sue are beneficial owners of the trust.

Examples

- Now assume John owns 10% of ABC, Inc. stock and that the John Family Trust owns 90%. In order to determine if John is a beneficial owner we would have to look at substantial control in relation to him both are direct and indirect basis. In this example is not listed as a senior officer, board member, etc. He is also not listed as the trustee. Therefore he would not be a beneficial owner. Jane and Sue would still be beneficial owners.
- What if John or the grantor of the trust with a right to revoke or withdraw assets or he was an individual with authority to dispose trust assets. In all likelihood he would be a beneficial owner because of that power and duty. Also, he likely would exceed the 25% ownership test and all the stock outright in 100%, 10% direct 90% indirect.

G. Trusts

- 6. Corporate Trustees. A corporate trustee refers to a legal entity rather than individual exercising the powers of a trustee in a trust agreement or arrangement.

G. Trusts

- a. If a reporting company’s ownership interests are owned or controlled through a trust arrangement with a corporate trustee, the reporting company should determine whether any of the corporate trustee’s individual beneficial owners indirectly own or control at least 25 percent of the ownership interests of the reporting company through their ownership interests in the corporate trustee.

Example

- Bubba is an individual that owns 60 percent of the corporate trustee of a trust, and that trust holds 50 percent of a reporting company's ownership interests. Bubba, owns or controls 30 percent (60 percent × 50 percent = 30 percent) of the reporting company's ownership interests and is therefore a beneficial owner of the reporting company.

- Now assume that if the same trust only holds 30 percent of the reporting company's ownership interests, the same individual corporate trustee owner only owns or controls 18 percent (60 percent × 30 percent = 18 percent) of the reporting company, and thus is not a beneficial owner of the reporting company by virtue of ownership or control of ownership interests.

G. Trusts

- b. The reporting company may, but is not required to, report the name of the corporate trustee in lieu of information about an individual beneficial owner only if all of the following three conditions are met:
  - the corporate trustee is an entity that is exempt from the reporting requirements;
  - the individual beneficial owner owns or controls at least 25 percent of ownership interests in the reporting company only by virtue of ownership interests in the corporate trustee; and
  - the individual beneficial owner does not exercise substantial control over the reporting company.

- c. In addition to considering whether the beneficial owners of a corporate trustee own or control the ownership interests of a reporting company whose ownership interests are held in trust, it may be necessary to consider whether any owners of, or individuals employed or engaged by, the corporate trustee exercise substantial control over a reporting company. The factors for determining substantial control by an individual connected with a corporate trustee are the same as for any beneficial owner.

V. Company Applicant

A. Overview

- 1. Only reporting companies created or registered **on or after** January 1, 2024, will need to report their company applicants. This applies to domestic reporting companies created on or after January 1, 2024 or foreign reporting companies that first registered to do business in the United States on or after January 1, 2024.
- 2. A company that must report its company applicants will have only up to two individuals who could qualify as company applicants.
- 3. A reporting company is not required to report a company applicant if it is either:
- a. A domestic reporting company created **before January 1, 2024** or
- b. A foreign reporting company first registers new business a United States before January 1, 2024.

B. What is a Company Applicant?

- 1. All company applicants must be individuals. No legal entities can be company applicants. There can be no more than two company applicants per reporting company.

- 2. There are two categories of company applicants.

- **a. Direct Filers.** The individual must be identified by all reporting companies that have a company applicant reporting requirement. This is an individual who directly file the document that created domestic reporting company or the individual who directly file the document that first registered a foreign reporting company. The individual will have actually physically or electronically filed the document with a Secretary of State or similar office.

B. What is a Company Applicant?

- **b. Directs or Controls the Filing Action**. This would involve an individual that is only required and is involved in the filing the document that created her first registered the company. To reiterate, this is an individual who was primarily responsible for directing or controlling the filing of the creation or first registration document. This individual is viewed as the company applicant even though they did not actually file the document with the Secretary of State or similar office.

- 3. In determining a company applicant, it is not relevant who signs the creation or registration of the documents as an incorporator.

- 4. To determine who is primarily responsible for directing or controlling the filing of the document, consider who is responsible for making the decisions about the filing of the document, such as how the filing is managed, what content the document includes, and when and where the filing occurs. The following three scenarios provide examples.

Examples

- John is an attorney who completes a company creation document using information provided by a client, and then sends the document to a corporate service provider for filing with a secretary of state. John is the company applicant who is primarily responsible for directing or controlling the filing because they prepared the creation document and directed the corporate service provider to file it. The individual at the corporate service provider is the company applicant who directly filed the document with the secretary of state. In other words both our company applicants.

- John as an attorney instructs a paralegal to complete the preparation of Articles of Formation. John directs the paralegal and does not do it himself. Before directing the corporate service provider to file the document, the attorney in the individual at the corporate service provider who files the document our company applicants. The paralegal is not an applicant because the attorney played a greater role in the paralegal in making substantive decisions about the filing of the document.

Examples

- If a client initiates a company creation directly by asking a corporate service provider to file the document. The company, the client is primarily responsible for directing or controlling the filing the client would be a company applicant along with the individual at the corporate service provider who files the document.

- John has created a new company by preparing the necessary documents to correct the company and he filed articles of incorporation with the state of Texas. He either did it in person or used an online portal. No one else was involved in the filing process. John is a company applicant because he directly file the document that created the entity. The state of Texas and employees of the secretary of the state of Texas though they process the creation they are not viewed as company applicants.

Examples

- John created a company. John prepared the articles of incorporation and he directed Betty to file the document with the secretary of the state of Texas. Betty filed the document directly through the online portal. Both John and Betty are company applicants. Betty did the filing directly. John was primarily responsible for directing and controlling the filing by Betty. Both are company applicants.

- Note: Regarding Betty she may be a company applicant as well if she was John's spouse, business partner, attorney or Accountant.

B. What is a Company Applicant?

- **5. CPAs and Attorneys**

- a. A CPA or Attorney could be a company applicant, depending on their role in filing the document that creates or registers a reporting company. In many cases, company applicants may work for a business formation service or law firm.

- b. A CPA or Attorney may be a company applicant if they directly filed the document that created or registered the reporting company. If more than one person is involved in the filing of the creation or registration document, an accountant or lawyer may be a company applicant if they are primarily responsible for directing or controlling the filing.

Example

- An attorney at a law firm that offers business formation services may be primarily responsible for overseeing preparation and filing of a reporting company's incorporation documents. A paralegal at the law firm may directly file the incorporation documents at the attorney's request. Under those circumstances, the attorney and the paralegal are both company applicants for the reporting company.

- Under Texas Law, an entity can be formed through the Texas Secretary of State website. John Smith a CPA files articles of incorporation on behalf of a new client. The Texas Secretary of State views the online portal for filing as public domain. The CPA would not be in trouble for practicing law without a license. However, they would likely be a company applicant.

B. What is a Company Applicant?

- 6. Use of Automated Incorporation Services

- a. If a business formation service only provides software, online tools, or generally applicable written guidance that are used to file a creation or registration document for a reporting company, and employees of the business service are not directly involved in the filing of the document, the employees of such services are not company applicants. For example, an individual may prepare and self-file documents to create the individual's own reporting company through an automated incorporation service. In this case, this reporting company reports only that individual as a company applicant.

A. Overview

- 7. Third Party Courier or Delivery Service
- a. A third-party courier or delivery service employee who only delivers documents to a secretary of state or similar office is not a company applicant provided they meet one condition:
- i. The third-party courier, the delivery service employee, and any delivery service that employs them does not play any other role in the creation or registration of the reporting company.
- ii. The individual who requested the third-party courier or delivery service to deliver the document will typically be the company applicant.

Example

- John, an attorney at a law firm is involved in the preparation of incorporation documents. John directs the paralegal to file the documents. The paralegal requests a third party delivery service to deliver the articles of incorporation to the Texas Secretary of State’s office. The paralegal is the company applicant who directly files the documents, the attorney who was involved in the preparation and who directed the paralegal to file the documents is also the company applicant. The courier who delivered it is not an applicant.

A. Overview

- c. If a courier is employed by a business formation service, law firm or other entity that plays a role in the creation registration of the reporting company, like drafting the documents or compiling information to be submitted as part of the documents delivered FinCEN considers the courier to have directly file the documents and is thus a company applicant. (See FAQ E .6)

Example

- John is a member of employee at ABC law firm. John works in the mailroom of the law firm He’s instructed by the attorney to deliver articles of incorporation to the Secretary of State’s office. The attorney prepared the documents and gave them to the employee drawn in the mailroom. Both John and the mailroom employee are company applicants and required to be disclosed as such on the reporting requirements.

A. Overview

- 8. Company Applicant Reporting for Existing Companies. If reporting company was created or registered register before January 1, 2024, you do not need to report any information on the company applicant for the reporting company.

C. Removal

- 1. A company applicant may not be removed from a BOI report even if the company applicant no longer has a relationship with the reporting company.

- 2. A reporting company created on or after January 1, 2024, is required to report company applicant information in its initial BOI report, but is not required to file an updated BOI report if information about a company applicant changes.

VI. Reporting Requirements

A. Overview

- 1. The information that needs to be reported depends on when the company was created or registered.

- 2. To reiterate, if a reporting company **was created or registered before January 1, 2024**, the reporting company only needs **provide information about itself and beneficial owners.**

- 3. If the reporting company **was created or registered on or after January 1, 2024** reporting company must **provide information not only about itself as well as beneficial owners and company applicants.**

A. Overview

- 4. Reporting companies may complete BOIRs electronically by accessing the BOI E-Filing portal at https://boiefiling.fincen.gov (accessible beginning on January 1, 2024). The E-Filing portal permits a reporting company to choose one of the following filing methods to submit a BOIR:
  - Upload finalized PDF version of BOIR and submit online.
  - Fill out Web-based version of BOIR and submit online.

A. Overview

- a. A reporting company may submit its BOIR through either of these methods, both of which require the filing to be done online as BOIRs cannot be mailed or faxed to FinCEN.
- b. The person who submits a BOIR will need to provide their name and email address to FinCEN.
- c. The person who submits a BOIR will receive confirmation of submission when a BOIR is accepted by FinCEN.

B. Filing Information

- **1. Type of Filing**. When the client or third party begins the process of filing they must indicate the type of filing. There are four (4) types of filing:

- a. Initial Report.
- b. Corrected Prior Report
- c. Update Prior Report
- d. Newly Exempt Report

- 2. If either of these the Reporting Company Information associated with one of these types of filings requires the legal name, tax identification type (SSN/ITIN, EIN, foreign), the tax identification number and Country and jurisdiction if there is a foreign tax ID number.

C. Information to Report – Information Provided on Reporting Company

- 1. This is in Part I of the form. The information of the reporting company must provide includes the following:

C. Information to Report – Information Provided on Reporting Company

- Its legal name;
- Any trade names, “doing business as” (d/b/a), or “trading as” (t/a) names;
- The current street address of its principal place of business if that address is in the United States (for example, a U.S. reporting company’s headquarters), or, for reporting companies whose principal place of business is outside the United States, the current address from which the company conducts business in the United States (for example, a foreign reporting company’s U.S. headquarters);
- Its jurisdiction of formation or registration; and
- Its Taxpayer Identification Number (or, if a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of the jurisdiction).

C. Information to Report – Information Provided on Reporting Company

- 2. If the Reporting Company has both a legal name and an assumed name, both must be included.
- 3. A reporting company will also have to indicate whether it is filing an initial report, or a correction or an update of a prior report.
- 4. Note also there is no annual reporting requirement. Reporting companies generally file it initial report and then make update or correct as needed.
- d. The reporting company must use the United States Street address and cannot use a PO Box.
- e. For a foreign reporting company, the country and jurisdiction of origin or registration must be included.
- f. There is also a box to check to imitative reporting company was create a register before January 1, 2024.
- **5. Address of Principal Place of Business of Reporting Company**

C. Information to Report – Information Provided on Reporting Company

- a. If a reporting company does not have a principal place of business in the United States, then the company must report to FinCEN as its address the primary location in the United States where it conducts business.

- **Note**: How does this work for a virtual business that does not have a physical address?

- What about a home-based business is conducted online? Likely the physical address would be the residential address of the home-based business.

- b. If a reporting company has no principal place of business in the United States and conducts business at more than one location within the United States, then the reporting company may report as its primary location the address of any of those locations where the reporting company receives important correspondence.

C. Information to Report – Information Provided on Reporting Company

- c. If a reporting company has no principal place of business in the United States and does not conduct business functions at any location in the United States, then its primary location is the address in the United States of the person that the reporting company, under State or other applicable law, has designated to accept service of legal process on its behalf. In some jurisdictions, this person is referred to as the reporting company's registered agent, or the address is referred to as the registered office. Such a reporting company should report this address to FinCEN as its address.

C. Information to Report – Information Provided on Reporting Company

- 6. FinCEN identifier (FinCEN ID) For Reporting Company

- a. A FinCEN identifier is a unique identifying number that FinCEN will issue to an individual or reporting company upon request after the individual or reporting company provides certain information to FinCEN.

- b. An individual or reporting company mail received one FinCEN identifier.

- c. An individual or reporting company is not required to obtain a FinCEN identifier. Hence, the request for the ID number is optional. For a reporting Company, the Company Applicant makes the request.

- d. The Reporting Company may include FinCEN identifiers in its BOI report instead of certain required information about beneficial owners or company applicants.

C. Information to Report – Information Provided on Reporting Company

- e. In other words, the FinCEN identifier can be a number assigned to the Reporting company or a beneficial owner or both.

- f. When a beneficial owner or company applicant has obtained a FinCEN identifier, reporting companies may report the FinCEN identifier of that individual in the place of that individual's otherwise required personal information on a beneficial ownership information report. The Company Applicant would use the ID number in the future.

- g. A reporting company may report another entity's FinCEN identifier and full legal name in place of information about its beneficial owners when three conditions are met:

B. Filing Information

- The other entity obtains a FinCEN identifier and provides it to the reporting company;
- The beneficial owners hold interests in the reporting company through ownership interests in the other entity; and
- The beneficial owners of the reporting company and the other entity are the exact same individuals.

B. Filing Information

- h. Reporting companies may request a FinCEN identifier by checking a box on the beneficial ownership information report upon submission. This would be Part I: Reporting Company Information. After the reporting company submits the report, the company will immediately receive a unique FinCEN identifier.

- i. If a reporting company wishes to request a FinCEN identifier after submitting its initial beneficial ownership report, it may submit an updated beneficial ownership information report requesting a FinCEN identifier, even if the company does not otherwise need to update its information.

B. Filing Information

- 7. Authorization to Request FinCEN identifier on behalf of an Individual. Anyone authorized to act on behalf of an individual may request a FinCEN identifier on the individual's behalf on or after January 1, 2024.

- a Reporting companies with a FinCEN identifier must update or correct the company's information by filing updated or corrected beneficial ownership information report as needed.

D. Information to Report – Information Provided Regarding Company Applicant

- 1. This is in Part II of the form.

- 2. The information reporting companies record provide regarding the company applicant includes the following:
  - The individual's name;
  - Date of birth;
  - Address; and
  - An identifying number from an acceptable identification document such as a passport or U.S. driver's license, and the name of the issuing state or jurisdiction of identification document.

D. Information to Report – Information Provided Regarding Company Applicant

- a. The Address of the Company Applicant can either be a residential address or business address. If the company that works in corporate formation (i.e. an attorney or corporate formation agent) the reporting company must report the company applicant's business address. Otherwise, the reporting company must use the company applicants residential address.

- b. The reporting company will also have to report an image of the identification document used to obtain the identifying number. The type of identification document that can be provided include the following:
  - State Issued Driver's License
  - State/Local Tribe Issued ID
  - US Passport
  - Foreign Passport

- None of the above to be expired.

- Note: The identifying number in association with the identifying documents must be provided.

D. Information to Report – Information Provided Regarding Company Applicant

- c. The jurisdiction in which the identifying document provided was issued must be included this could include Country, Foreign Jurisdiction, State, Local/Tribunal, or other local/Tribunal Descriptions.

- **4. FinCEN ID**. The Company Applicant has the option to apply for and include a FinCEN identifier also known as a FinCEN ID. This is a number associated with the Reporting Company or beneficial owner. The Company Applicant would check a box requesting to receive the FinCEN identifier.

- **5. Authorization to Request FinCEN identifier on behalf of an Individual**. Anyone authorized to act on behalf of an individual may request a FinCEN identifier on the individual's behalf on or after January 1, 2024.

- a Reporting companies with a FinCEN identifier must update or correct the company's information by filing updated or corrected beneficial ownership information report as needed.

E. Information to Report – Information Provided Regarding Beneficial Owners

- 1. This is in Part III of the form.

- 2. The information the reporting company is required to provide regarding beneficial owners includes the following:
  - The individual's name;
  - Date of birth;
  - Residential address; and
  - An identifying number from an acceptable identification document such as a passport or U.S. driver's license, and the name of the issuing state or jurisdiction of identification document.

E. Information to Report – Information Provided Regarding Beneficial Owners

- a. If the Beneficial owner is a parent or guardian of a minor child a box must be checked accordingly information regarding that parent or guardian of the minor child will be required to be submitted. This would include the information identified above.

- b. If the beneficial owner is associated with an exempt entity a box would also have to be checked.

- b. The reporting company will also have to report an image of the identification document used to obtain the identifying number.

E. Information to Report – Information Provided Regarding Beneficial Owners

- c. The same form of identification as used for the Company Applicant would apply here as well.
- 3. Beneficial Owner Physical Address
- a. The residential address that is current at the time of filing should be reported to FinCEN.
- b. An updated report should be submitted within 30 calendar days if the address, or any other information previously reported, changes. (See FAQ F .11)
- 4. FinCEN identifier (FinCEN ID) For Beneficial Owner

E. Information to Report – Information Provided Regarding Beneficial Owners

- a. Individuals may request a FinCEN identifier starting January 1, 2024, by completing an electronic web form at https://fincenid.fincen.gov. Obtaining a FinCEN identifier for an individual requires the requesting party to create a Login.gov account, which is tied to the individual receiving the FinCEN identifier. Individuals who receive a FinCEN identifier should ensure their login credentials, including email address and related multi-factor information associated with their Login.gov account, are saved for future reference.

- b. Individuals will need to provide the following:
  - Full legal name,
  - Date of birth,
  - Physical address,
  - Unique identifying number and issuing jurisdiction from an acceptable identification document, and
  - An image of the identification document.

E. Information to Report – Information Provided Regarding Beneficial Owners

- After an individual submits this information, they will immediately receive a unique FinCEN identifier.

- c. When a beneficial owner has obtained that ID number they may use that ID number in place of the individuals otherwise required personal information on a beneficial ownership information report.

- d. Again, individuals must update or correct information through the FinCEN identifier application that is used to request the FinCEN identifier. Individuals must report any change to the information they submitted no later than 30 days after the date on which the change has occurred. Likewise, if there is an accuracy in the information, the individual must correct information no later than 30 days after the date the individual became aware of the accuracy or had reason to know of it.

E. Information to Report – Information Provided Regarding Beneficial Owners

- e. Presently, there is no way to deactivate a beneficial owners FinCEN identifier if they are no longer associated with the Reporting Company. This would include the company applicant if the company applicant change.

F. Acceptable Forms of Identification

- 1. To be clear under the Corporate Transparency Act it requires a unique identification number found in one of the following acceptable forms of identification regarding individuals:
  - A non-expired U.S. driver's license (including any driver's license issued by a commonwealth, territory, or possession of the United States);
  - A non-expired identification document issued by a U.S. state or local government, or Indian Tribe;
  - A non-expired passport issued by the U.S. government; or
  - A non-expired passport issued by a foreign government (permitted only when an individual does not have one of the other three forms of identification listed above).

- 2. These form of identification are directly associated with the Company Applicant and Beneficial Owner.

- 3. Multiple Last Names. If an individual's name consists of a first name and multiple last names (e.g., a father's last name and another's last name), the multiple last name elements would be entered in the last name field and the first name entered in the first name field.

Example

- The website has the following example: If an individual's name is Juan (first name) Vega (first last name) Santiago (second last name), "VEGA SANTIAGO" would be entered in the last name field and "JUAN" would be entered in the first name field. This would be the case for a beneficial owner and company applicant.

- If an individual's name typically is written with the family name first, that family name should be entered in the last name field.

- a. Middle names if it is on the identification should be included.

F. Acceptable Forms of Identification

- 4. Exception to Identification. If a beneficial owner or company applicant’s identification document does not include a photograph for religious reasons, the reporting company may nonetheless submit an image of that identification document when submitting its report, as long as the identification document is one of the types of identification accepted by FinCEN, such as a non-expired State-issued identification document.

- 5. The filing through the FinCEN is a mandatory filing requirement. The fact that your client has a business entity and files the PIR or the OIR report with the Comptroller of Public accounts does not meet the filing requirement.

G. Addresses

- 1. US Territories. When address is in the US territory, the territory code must be selected in the US or US territory field. The system will automatically fail the state field with the relevant code.

- 2. Non-US Addresses. When an address is not in the United States, enter the street address, city, country/jurisdiction, and foreign postal code. If a foreign address contains information that does not exactly match the BOIR address fields, provide the foreign address information in the existing BOIR address fields regardless of whether the field fully matches the address information. All foreign address information should be reflected somewhere in the BOIR address fields provide.

VII. Initial Report

A. General

- 1. If your company existed before January 1, 2024, it must file its initial beneficial ownership information report by January 1, 2025. The box indicating initial report would be checked on the filing information section of the form.

- 2. If your company was created or registered on or after January 1, 2024, and before January 1, 2025, then it must file its initial beneficial ownership information report within 90 calendar days after receiving actual or public notice that its creation or registration is effective.

A. General

- a. This 90-calendar day deadline runs from the time the company receives actual notice that its creation or registration is effective, or after a secretary of state or similar office first provides public notice of its creation or registration, whichever is earlier.

- 3. If your company was created or registered on or after January 1, 2025, it must file its initial beneficial ownership information report within 30 calendar days after receiving actual or public notice that its creation or registration is effective.

B. Determination of Date Company Created or Registered

- 1. For a company created or registered after January 1, 2024 date of determination of creation or registration is the earlier of the date on which:
  - The reporting entity receives actual notice that its creation or registrations become effective or
  - a Secretary of State or similar office first provides public notice, such as through a publicly accessible registry, that the domestic reported company has been created or that the foreign company has been registered.

B. Determination of Date Company Created or Registered

- 2. Per FinCEN, they recognize that in some states, automated systems provide notice of creation or registration to newly created or registered companies. While in other states, no actual notice of creation or registration is provided, and newly created companies receive notice through the public posting of state records. FinCEN believes that individuals who create or register reporting companies will likely stay apprised of creation or registration notices or publications, given those individuals' interest in establishing an operating business or engaging in the activity for which the reporting company is created.

B. Determination of Date Company Created or Registered

- 3. Likewise, it is important the taxpayer who may be a reporting entity that incorporated after January 1, 2024 have a federal taxpayer identification number. This could be an issue with foreign individuals who have a beneficial ownership reporting requirement as it takes 6 to 8 weeks to obtain that PIN number for foreign person the sooner the application for the TIN, the better result for the taxpayer.

C. Consolidated or Combined Reporting

- 1. A parent company cannot file a single report on behalf of a group of companies. In other words there is no combined or consolidated reporting. Any company that meets the definition reporting company is not exact must file its own BOI report.

D. Inclusion of Historical Beneficial Owners

- 1. The initial report should only include the beneficial owners as of the time of filing. There is no requirement to include historical beneficial owners in the file.

E. Exempt Entities that are no Longer Exempt

- 1. Generally, an entity that loses its exempt status must file a BOI Report within 30 days after the date it is no longer able to meet the requirement or criteria or any exception.

- 2. A reporting company created or registered to do business before January 1, 2024 and loses their exempt status will still have until January 1, 2025 file its initial report.

- 3. Previously exempt entities that existed before 2024 and loses their exemption in 2024 will receive the benefit of a timeline that is the longer of either:
  - The remaining days left in one year filing period for existing companies or
  - The 30 calendar day. For companies that lose their exempt status.

Example

- ABC Company is no longer an exempt large operating company on February 1, 2024. ABC company will have until January 1, 2025 file its initial report as a reporting company.

- Assume now that ABC company is no longer exempt large operating company on December 15, 2024. ABC company will have until January 14, 2025 to file its initial report. (30 days).

VIII. Updated Report

A. General

- 1. The Company Applicant would indicate that the report is an update report by checking the box on the Filing Information section which is the beginning of the report.

- 2. a. If there is any change to the required information about your company or its beneficial owners in a beneficial ownership information report that your company filed, your company must file an updated report no later than 30 days after the date of the change.

- b. A reporting company is not required to file an updated report for any changes to previously reported information about a company applicant.

B. What would Constitute a Change?

- 1. Any change to the information reported for the reporting company. These could include, but are not limited to the following:
  - A registering a new business name or assumed business name.
  - A change in beneficial owners, such as a new CEO, or a sale that changes who meets the ownership interest threshold of 25 percent.
  - When the beneficial owner dies or a percentage change in ownership under the ownership test
  - A Change in substantial control
  - Any change to a beneficial owner’s name, address, or unique identifying number previously provided to FinCEN.
  - A beneficial owner obtaining a new driver’s license or other identifying document that includes a changed name, address, or identifying number. The change would also require including an image of the new identifying document.

B. What would Constitute a Change?

- 2. Any change to the reporting company's beneficial owners that should be done in a 30 day timeframe of when the deceased owner's estate is settled. If there any new beneficial owners they would be identified at that time.

- 3. There is no requirement to report a company's termination or dissolution.

- 4. Example of Updated Reporting

B. What would Constitute a Change?

- Example

- ABC, Inc. is a reporting entity and has decided to change its legal name to ABC, Co. Under this they would have to file an updated report. The update would not be limited to the new name. ABC would be required to file updated report to include not only the new name but also unchanged information about the company, beneficial owners and if applicable company applicant. In other words a change would require a complete report to be filed.

B. What would Constitute a Change?

- 5. An updated report is not required when the type of ownership interest a beneficial owner has in a reporting company changes.

- Examples

- ABC, Inc. is a reporting entity and previously reported preferred stock under ownership test. The company has elected to have a conversion of preferred stock to common stock. There is no requirement to file updated report. The type of ownership interest is not a requirement for reporting just the ownership test 25%.

- ABC, Inc. is a reporting entity and Chris reported efforts talk under ownership test. The company has elected to have convert preferred stock to common stock. Sean previously owned 30% of preferred stock but is now to receive 40% on it conversion. That change will have to be reported because it’s a change in the percentage not the change in the type of ownership.

C. Late Filing

- 1. An updated BOI report can be submitted to FinCEN at any time. However, the reporting company is responsible for ensuring that updates are filed within 30 days of a change occurring.

- 2. If a reporting company has engaged a third-party service provider to file BOI reports and updates on its behalf, then it should communicate any changes to its beneficial ownership information to the third-party service provider with enough time to meet the 30-day deadline.

IX. Corrected Report

A. Inaccuracies

- 1. If an inaccuracy is identified in a BOI report that your company filed, your company must correct it no later than 30 days after the date your company became aware of the inaccuracy or had reason to know of it.
- 2. This includes any inaccuracy in the required information provided about your company, its beneficial owners, or its company applicants.
- 3. The same 30-day timeline applies to inaccuracies in information submitted by an individual in order to obtain a FinCEN identifier.
- 4. The box titled Corrected Report would be checked on the Information Section of the form.

B. What would Constitute a Change?

- 5. For both a corrected report updated report, A reporting company that filed its prior BOI report using the fillable PDF version may update its saved copy and resubmit to FinCEN. If a reporting company used FinCEN’s web-based application to submit the previous BOI report, it will need to submit a new report in its entirety by either accessing FinCEN’s web-based application to complete and file the BOI report, or by using the PDF option to complete the BOI report and upload to the BOI e-Filing application.

X. Newly Exempt Entity

A. General

- 1. This box would be checked on the filing information page of the form. A reporting company filed a beneficial ownership information report but then becomes exempt from filing the report, the company should file an updated report indicating that it is no longer a reporting company.
- 2. An updated BOI report for a newly exempt entity will only require that:
  - the entity identify itself; and
  - check a box noting its newly exempt status.

A. General

- 3. The client does not need report information about existing beneficial owners ownership interest in a reporting company if the ownership interest held through one or more of the exempt entities previously discussed. The client is required to report the name of the exempt entities instead of information about the individual who is the beneficial owner of the company.

- Example

- ABC, Inc. is a Large Operating Company that owns 50% of the ownership interest in XYZ Company. XYZ Company is a reporting company. ABC, Inc. is exempt because they follow the definition of a large operating company. John bull owns 50% of the large operating company as an indirect ownership in XYZ Company of 25% (50% x 50% = 25%) the reporting would name the large corporate company instead of John’s personal information.

XI. Use of Third Party Service Provider

A. General

- 1. Reporting Companies may use third-party service providers to submit beneficial ownership information reports. The third-party service providers will have the ability to submit the reports via the website for application programming interface.

B. Evidence of Filing

- 1. A reporting company that desires to use a third-party service provider must retain evidence of confirmation that the report has been successfully filed by the third-party provider. Beginning January 1, 2024, the system does provide for acknowledgment of submission success or failure in the submitter should be able to download a transcript of the report. It is a requirement that the reporting company retain the information as confirmation of filing.

XII. Compliance and Enforcement

A. Penalties

- 1. Under the Corporate Transparency Act, a person who violates the reporting requirements may be subject to civil bounties up to $500 for each day the violation continues. Civil penalties will be adjusted in late for inflation. Presently they are $591 per day for a violation.

- 2. Likewise, a reporting entity, company applicant or beneficial owner may be subject to criminal penalties of up to two years imprisonment and a fine of up to $10,000. Potential violations would include willful failing to file the information report, filing a false report or willfully failing to correct or update a report.

- 3. Criminal penalties of a fine of up to $250,000 or imprisonment of up to five years (or both). (31 U.S.C. § 5336(h)(3)(B).)

A. Penalties

- 4. If the unauthorized disclosure or use is part of a pattern of illegal activity involving more than $100,000 in any 12-month period, the criminal penalty is increased to a fine of up to $500,000 or imprisonment of up to ten years (or both) (31 U.S.C. § 5336(h)(3)(B)(ii)(II)

- 5. For 2024, since this is new to avoid the penalty an updated or corrected report can be made within 90 days of the deadline for the original report. (See FAQ K. 1)

B. Liability Issues

- 1. Both individuals and corporate entities can be held liable for willful violations.
- 2. This includes not only an individual who actually files or attempts to file false information but also eating one who willfully provides the filer with false information to report.
- 3. Both individuals and corporate entities may be held liable for willfully failing to complete her update beneficial ownership information. Individuals can be held liable if outer cost of failure or senior officer at the company at the time of the failure.
- 4. An individual who willfully files a false or fraudulent beneficial ownership information report on a company's behalf may be subject to the same civil and criminal penalties as the reporting company and its senior officers.
- 5. Enforcement action can include those who willfully called a recorded company's failure to submit complete or updated information this can include the beneficial owner, company applicant and the reporting company itself.

C. Reporting Company Responsibility for Filing

- 1. FinCEN makes it very clear that it is the responsibility of the reporting company to identify the beneficial owners and company applicants and report such accurately to FinCEN. (See FAQ K. 4)

- 2. At the time the filing is made, each reporting company is required to certify the report or application is true, correct and complete.

D. Conflict between Reporting Company and Beneficial Owner

- 1. According to FinCEN on its website, reporting companies must put in place mechanisms to ensure beneficial owners will keep the reporting company apprised of changes that they must either update or correct. The reporting is a legal requirement subject to penalties. (See FAQ K. 5)

XIII. Dissolving and FinCEN Reporting Requirements

A. Overview

- 1. FinCEN at present has not provided any specific guidance on liquidation and dissolution of a Reporting Entity.
- 2. A liquidated or dissolved business is not an exempt entity. It is not a newly exempt entity to be reported as such as an update or correction.
- 3. An argument could be made that a liquidated or dissolved business is inactive entity. Remember, an inactive entity is exempt from reporting. There are six criteria that must be met. These include the following:

A. Overview

- The entity was in existence on or before January 1, 2020.
- The entity is not engaged in active business.
- The entity is not owned by a foreign person whether directly or indirectly, wholly or partially.
- The entity has not experienced a change in ownership in the preceding 12 month period.
- The entity has not sent or received any funds in the amount greater than $1,000 dollars, either directly or through any financial account in which the entity or affiliate of the entity had an interest, in the preceding 12 months.
- The entity does not otherwise hold any kind or type of assets, whether in the United States or abroad, including any ownership interest in a corporation, LLC or similar entity.

Examples

- ABC Company was formed January 1, 2017. The business has been active for over a year. The total amount of assets is less than $1,000. There has been no revenue from the business and no advertising for well over a year. The business is not owned by a foreign person but all the stock is owned by Bubba (100% stock ownership). Bubba wishes to dissolve ABC Company in 2024. He likely would not file with FinCEN as he meets the criteria.

- Now so ABC Company was formed January 1, 2017 but the business ceased activity in 2024. All the other criteria to be deemed an active entity exists. Bubba owns 100% of the stock and thus meets the criteria of being a beneficial owner. There is no timeline to determine whether a business is active or not under the Corporate Transparency Act. There is no dissolution exception. Bubba would likely file a report for 2024 at the end of the year. An argument could be made in 2025 that he is a newly exempt entity as an active entity. This will be erring on the side of conservatorship and caution under the rules.

Examples

- Note: In both examples above, A Certificate of Termination would have to be filed with the Secretary State as further evidence of the entity is now inactive entity.

- 4. Under the second illustration above, even if the business was formed in 2024 or 2025 and shut down within the year all reporting would likely be required.

Examples

- 5. Note that FinCEN has specifically required an updated report in the event an entity's reporting status changes. At a minimum, a report should be sent regarding a change in the reporting status of the company. In reality given the nature of the penalties that can be imposed on an individual personally, especially without any potential corporate shield, an initial report should probably be sent along with a report of a change in an entity's reporting status. The requirements for reporting a new exempt status is simply to identify the reporting company and indicate the new exempt status.

- 6. Caution must be taken regarding the dissolution or withdrawal because of the severity of the penalties being imposed.

B. Involuntary Termination of a Business Entity in Texas

- 1. If the corporate privileges or right to transact business of a taxable entity are forfeited and the taxable entity doesn’t pay the amounts necessary to revive its corporate privileges within 120 days, then the Comptroller is required to certify the name of the corporation to the Texas Attorney General and Secretary of State. (See Texas Tax Code Section 171.301, 171.3015 and 171.302)

- 2. Generally when the corporate privilege or right to transport business is forfeited, one of two things can occur:

- a. The Attorney General may file a suit to forfeit the charter or certificate authority of the taxable entity or

- b. The Secretary of state may forfeit the taxable entities charter, certificate of registration without a judicial proceeding.

B. Involuntary Termination of a Business Entity in Texas

- 3. Once a taxable entity’s charter, certificate, or authority is forfeited, the entity becomes what’s known as a “terminated entity.” This means that the entity is prohibited from continuing its existence for the purpose of continuing its business or affairs unless the entity is reinstated.

B. Involuntary Termination of a Business Entity in Texas

- 4. The question becomes as to whether the involuntary terminated entity is a newly exempt entity for purposes of the reporting rules to FinCEN. If the entity fits the six criteria he considered an active entity then the argument can be made it is not a reporting requirement. However, if the entity is an active trade or business and did not comply with the filings under the franchise tax board the revived PIR all our reports, the involuntary termination by the Secretary of State only revokes the ability to conduct business in Texas. It is unlikely in the federal law to be deemed a termination or revocation of the charter or original filing. Remember, the beneficial ownership information report is based on the original chartering or original filing.

B. Involuntary Termination of a Business Entity in Texas

- 5. Under Texas law, involuntary termination is recorded at the Secretary of State's website but the initial incorporation or chartering remains on the site is not taken off. Therefore the federal government could make an argument that the reporting entity is still has a requirement even on a de facto basis. This uncertainty remains in play and could expose the company applicant, the beneficial owners to the penalties for not filing timely.

XIV. Bankruptcy Issues

A. Uncertainty – In re BOA Nutrition, Inc., No. 23-03665-5-PWM (Bank. E.D.N.C.)

- 1. On February 28, 2024, the bankruptcy administrator for the US Bankruptcy Court for the Eastern District of North Carolina move the bankruptcy court for an order determining that Chapter 7 trustee has no duty under the Corporate Transparency Act to report a Chapter 7 debtor beneficial ownership information to FinCEN .

- 2. The Bankruptcy Administrator acknowledged that most business debtors in Chapter 7 cases will be subject to the CTA's reporting requirements, including the debtor in the case at bar. However, the Bankruptcy Administrator asserted that bankruptcy trustees should have no duty to file these reports since they are representatives of the bankruptcy estate created upon the filing of the case.

A. Uncertainty – In re BOA Nutrition, Inc., No. 23-03665-5-PWM (Bank. E.D.N.C.)

- 3. The Administrator also noted that a bankruptcy estate is not included in the definition of a "reporting company" and bankruptcy trustee is not expressly included in the definition of "beneficial owner."

- 4. Since there is no case law currently addresses this question, the Bankruptcy Administrator asked the court to determine that a Chapter 7 trustee has no duty to report beneficial ownership information to FinCEN on the debtor's behalf. The bankruptcy court directed the U.S. Department of Treasury — the department to whom CTA reports would be submitted — to respond to the motion within 14 days. The United States Attorney for the Eastern District of North Carolina, on behalf of the U.S. Department of Treasury, then moved for an extension of 60 days to respond to allow "Treasury to properly consider the issues presented" before responding.

B. Other Bankruptcy Issues

- 1. The Corporate Transparency Act presents other issues in the context of bankruptcy even beyond the question of reporting requirements by Chapter 7 trustees.

- 2. In many bankruptcy cases, a corporate debtor is required to disclose a corporation that directly or indirectly owns 10% or more of any class of the debtor's equity interests or state that there is no entity to report. The CTA's reporting requirement is broader and requires the disclosure not only of corporations, but also of individuals. This creates potential issues for a bankruptcy estate to identify the individuals who are the beneficial owners of a debtor. The problem is further complicated if an entity that holds an equity interest is an LLC, because the LLC's members likely would have to be identified for CTA reporting purposes as well.

B. Other Bankruptcy Issues

- 3. Many Chapter 11 plans call for the voiding and cancellation of a debtor's security and equity interests. While in theory this should terminate the need to report such equity holders for CTA reporting purposes, further developments in the law are required to confirm this. Chapter 11 plans frequently call for the appointment of a liquidating trustee in liquidating Chapter 11 cases. It is unclear if a liquidating trustee has a CTA reporting obligation where the debtor is not immediately dissolved, but all of the debtor's assets and liabilities are transferred to a trust.

- 4. Many liquidating trustees are appointed following the sale of substantially all of a debtor's assets and many times the debtor's books and records can be unreliable. If a liquidating trustee lacks reliable records that would enable him to report through no fault of the trustee, will he or she be able to obtain an extension or exemption from the CTA's penalties? If a trustee cannot obtain an extension or exemption, bankruptcy estates will have to determine a work around to the issue.

B. Other Bankruptcy Issues

- 5. The CTA expressly exempts creditors of a reporting company from being considered a beneficial owner of the reporting company. However, creditors may become beneficial owners if the debt is converted to equity, unless another statutory exemption applies. Accordingly, the CTA's reporting requirements add another layer of complexity to consider.

- 6. It is not uncommon during preparations for a bankruptcy filing for an entity to appoint an independent director or a chief restructuring officer, which could trigger an obligation for reporting companies to file an updated report with FinCEN. Changes in officers and directors are also common when a company exits bankruptcy, again requiring updated reporting.

XV. Access to Beneficial Ownership information

A. Overview

- 1. On December 22, 2023, FinCEN published a final rule governing access to and protection of beneficial ownership information. According to FinCEN, beneficial ownership information reported to FinCEN will be stored in a "secure, non-public database using rigorous information security methods and controls typically used in the federal government to protect non-classified yet sensitive information systems at the highest security level." FinCEN has also announced that it plans to collaborate with authorized entities to ensure their systems are equally as secure and that they understand their roles and responsibilities in using the reported information for authorized purposes only.

A. Overview

- 2. The final rule states that FinCEN will permit federal, state, local, and tribal officials, as well as certain foreign officials who submit a request through a U.S. federal government agency, to obtain beneficial ownership information for authorized activities related to national security, intelligence, and law enforcement. Additionally, financial institutions that are subject to requirements relating to collecting and verifying beneficial ownership information in connection with customer due diligence requirements will have access to beneficial ownership information in certain circumstances, in each instance with the consent of the reporting company. Those financial institutions' regulators will also have access to beneficial ownership information when they supervise the financial institutions.

XVI. Constitutionality Beneficial Ownership Information Reporting Rule

A. National Small Business United v. Yellen, No. 5:22 –cv – 01448 – LCB (ND Ala.).

- **1. Basis of Lawsuit**

- On November 15, 2022, the national small business Association (NSBA) and a small business owner by the name of Winkles fought a lawsuit in the US District Court for the Northern District of Alabama challenging the Beneficial Ownership Information Reporting Role of the Corporate Transparency Act. The plaintiffs challenge the constitutionality of the rule asserting that the Corporate Transparency Act in seeking to combat money laundering and other illegal activity requires law abiding Americans to provide highly personal information to a government agency to be stored in a database for criminal enforcement purposes violating privacy protections. In addition, the powers and duties granted are vague and unduly burdensome on small businesses and in French on state powers to govern business. The plaintiff sought an immediate injunction against the implementation of the Beneficial Ownership Information Reporting Rules.

A. National Small Business United v. Yellen, No. 5:22 –cv – 01448 – LCB (ND Ala.).

- 2. Substantive Aspects of the Case

- The District Court determined that the specific issue in the case is as follows:

- Whether the Constitution gives Congress the power to regulate millions of entities and their stakeholders the moment they obtain a corporate status from a state?

A. National Small Business United v. Yellen, No. 5:22 –cv – 01448 – LCB (ND Ala.).

- 3. Governments Argument

- a. Standing Argument. The federal government argued that the plaintiffs did not have standing to bring the suit and that they failed to show any specific injury to support their claim.

- b. Foreign Affairs and Nationals Security. The government further argued that the Corporate Transparency Act mandate to require reporting companies to disclose beneficial ownership information is directly tied to Congress's power to conduct foreign affairs because such information is vital to US national security interests, assist national security, intelligence and law enforcement in countering money laundering, the financing of terrorism, other illicit acts and bring the US in line with international anti-money laundering and financing of terrorism standards known as AML/CFT standards.

A. National Small Business United v. Yellen, No. 5:22 –cv – 01448 – LCB (ND Ala.).

- c. Commerce Clause. The Government also indicated in the alternative that the Corporate Transparency Act was about exercise of Congresses power under the Commerce Clause because the Act regulates the channels of interstate and foreign commerce as well as activities that have a substantial effect on interstate and foreign commerce.

- d. Taxing Power and Necessary and Proper Clause. The government also argued the collection of the information is necessary and proper near ensure taxable income is appropriate reported. To support the argument the Government know that Congress provided for access to the information for tax ministration purposes.

A. National Small Business United v. Yellen, No. 5:22 –cv – 01448 – LCB (ND Ala.).

- 2. Court Ruling

- On March 1, 2024 the District Court determined that the Plaintiffs are in togs summary judgment as a matter of law. The court granted the plaintiffs request for relief by entering a declaratory judgment that the Corporate Transparency Act is unconstitutional because it exceeds the Constitution’s limits on Congress’s power. The Court made no ruling as to the constitutionality of the act on any other grounds. The District Court indicated that the Defendant are permanently enjoined from enforcing the Corporate Transparency Act solely against the plaintiff’s. Specifically, the District Court indicated that the beneficial ownership information reporting role was unconstitutional because the legislation cannot be justified as an exercise of congresses enumerated powers.

A. National Small Business United v. Yellen, No. 5:22 –cv – 01448 – LCB (ND Ala.).

- a. Standing: The Court disagreed and indicated that Mr. Winkles had standing because the beneficial ownership provisions compelled disclosure of personal information for law enforcement purposes which can be construed as a concrete emanate injury that is traceable to the government. In addition, since Mr. Winkles was a member of NSBA and had standing as an individual, the Association also had standing

- b. Foreign Policy. The District Court indicated in its ruling that what Congress was doing was not conducting foreign policy or regulating foreign affairs but rather injecting itself into domestic policy where congressional powers were limited.. The court went on to state that the act requiring disclosure of beneficial ownership information for entities that incorporate under a state law exceeds congressional authority meaning it exceeds the congresses enumerated powers. The court also indicated that the Act converts an astonishing amount of traditional local conduct into a matter for federal enforcement involves a substantial extension of federal police resources that the Act cannot justifies necessary and proper to carry out congresses foreign affairs powers.

A. National Small Business United v. Yellen, No. 5:22 –cv – 01448 – LCB (ND Ala.).

- c. Commerce Clause. The District Court indicated that the Corporate Transparency Act plain language does not regulate the channels and instrumentalities of commerce let alone commercial or economic activity. The District Court Judge said the Corporate Transparency Act failed to mention the word commerce in the statute all. The Court indicated that while some of the reporting companies would have to disclose beneficial ownership information and may indeed engage in commerce that is not sufficient to sustain the Act under the Commerce Clause because the Act applies to all domestic entities that are created by a document filed with the state or foreign entities that register to do business with the state. The Act neither regulates entities who engage in interstate commerce directly nor the channels for instrumentalities of commerce themselves.

A. Overview

- d. Taxing Power and Necessary and Proper Clause. The District Court Rejected the government argument as not enough further noting that it would be a substantial expansion of federal authority to permit Congress to bring his taxing power to bear just to collect useful data and allow tax enforcement officials to access that data.

A. Overview

- 3. Temporary Result of Decision

- The federal government cannot currently enforce the reporting rules against Mr. Winkles nor can they enforce it against the National Small Business Association and the members of that association as of March 1, 2024. The court's decision specifically stated that those parties are not required to report to FinCEN presently.

- 4. FinCEN and Treasury Response

- FinCEN responded by indicating it would comply with the District Court's Order as long as he remains in effect. Specifically, the government will not enforce the Corporate Transparency Act against the plaintiffs associate with the action. However, the government exerts continuing authority to enforce the law against nonparties and has continued to take that position. FinCEN further indicated that it will continue the implement the Corporate Transparency Act as required by Congress.

B. Appeal

- 1. On March 11, 2024 the federal government filed an appeal with the 11th Circuit Court of Appeals.

- 2. The Treasury argues in appeal that the Corporate Transparency Act falls within the purview of congresses economic regulatory authority under the Commerce Clause and the Necessary and Proper Clause of Article I of the Constitution. The Treasury reiterates that the primary purpose of the Act is to combat financial crimes such as money laundering, terrorism financing and tax fraud which Congress has historically legislated against. The Treasury Department also disputes the District Court's findings that the Act regulates the mere act of incorporation or formation.

B. Appeal

- The treasury argues that it regulates a class of entities which conduct commercial transactions in their own name not the name of the owners. And that the reporting requirement are triggered by the entity created by the filing of documents with a state because the enemies can enter into contracts, borrow money, incur liabilities and transfer property all of which can be the means by which the owners launder money or conduct illegal transactions. The Treasury argues that the mere act of incorporation or formation is not the regulation.

B. Appeal

- 3. In the Appellate brief, the attorneys for NSBA initially state that the Corporate Transparency Act does not target commercial activities. The NSBA cites the Supreme Court decision in National Federation of Independent Businesses v. Sebelius noting that the court held it has never permitted Congress to anticipate economic activity in order to regulate individuals not currently engaged in commerce. Commerce clause is not a general license to regulate an individual from cradle to grave simply because he or she predictably engage in a transaction. They further argued that under state law corporate formation is a governmental and ministerial act not a commercial or economic activity. Further they argue that many individuals create shell companies for law for noncommercial reasons such as individuals forming LLCs to hold family homes for personal security reasons or to create nonprofit associations without tax-exempt status. The Corporate transparency Does not target commercial activities. Rather, it targets entities at their formation and no further activity not even commercial activity is required to bring such entities under review. As such, the Act regulates noneconomic noncommercial activities that do not substantially affect interstate commerce.

B. Appeal

- 4. Fourth Amendment Search and Seizure Argument. The NSBA is now arguing that requiring businesses to submit beneficial ownership information for law enforcement purposes is a search and that the fourth amendment reflected the framers judgment that any claim government on the to make law enforcement easier cannot justify suspicion less searches of its citizens. The appellate brief indicated that collecting massive amounts of data from millions of law-abiding American small business owners is not a panacea to our law enforcement and national security threats and it’s not constitutional either. The reason the District Court never discuss the fourth amendment is because they found that the Corporate Transparency Act did not fall within congresses enumerated powers.

SECTION XII:

BUSINESS TAX CREDITS

I. Work Opportunity Tax Credit

A. Expansion

- 1. The WOTC is extended through the end of 2025.
- 2. Qualified Long-term Unemployment Recipient. The extension of the W OTC included expanding the targeted group of individuals to include qualified long-term unemployment recipients. qualified long-term unemployment recipient is any individual who on the day before the individual began work for the employer, or, if earlier that day the individual completed Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, in a period of unemployment that was not less than 27 weeks and includes a period (which may be less than 27 weeks) in which the individual received unemployment compensation under state or federal law.

B. Qualification

- 1. To qualify for the credit, an employer must first request certification by submitting IRS Form 8850, Pre-screening Notice and Certification Request for the Work Opportunity Credit, to their state workforce agency (SWA). Do not submit this form to the IRS.

- 2. Normally, Form 8850 must be submitted to the SWA within 28 days after the eligible worker begins work.

- 3. The credit is first figured on Form 5884, Work Opportunity Credit, and then is claimed on Form 3800, General Business Credit. Generally, the credit is equal to 40% of up to $6,000 of wages paid or incurred with a maximum credit of $,2400 for new hires in their first year of employment, that are a certified member of one of the targeted groups listed and who preferably sported hours of service for the employer.

B. Qualification

- 4. An employer with a certified employee who works lease 120 hours may be eligible for smaller credit amount. Up to $24,000 in wages may be considered when determining the credit for certain qualified veterans.

- 5. CCA202205024. The IRS Office of Chief Counsel advised that Section. 280E prohibits a taxpayer from entitlement to the work opportunity tax credit for wages paid or incurred in carrying on a business of trafficking in marijuana. The Chief Counsel's Office noted, under Section 280E, no deduction or credit is allowed for any amount paid or incurred during the tax year in carrying on any trade or business if such trade or business consists of trafficking in controlled substances within the meaning of the Controlled Substances Act.

II. Guidance on New Energy Efficient Homes Tax Credit

A. Notice 2023 – 65

- 1. The Services issued guidance on the new energy efficient home credit. The credit allows eligible homebuilders and renovators to claim a credit up to $5,000 per qualified new energy efficient home.
- 2. The actual amount of the credit depends on various eligibility requirements, including the type of home, its energy efficiency, and whether prevailing wage requirements are met for multifamily dwelling units.
- 3. To qualify for the credit, eligible contractors must build, substantially renovate or rehabilitate a qualified new energy efficient home located in the United States. The contractor must also own the home and have a basis in it during construction and sell or lease the home to a person for use as a residence.
- 4. For homes acquired in 2023 through 2032, the credit amount ranges from $500 to $5,000, depending on the certification achieved and standards met. These standards include Energy Star program requirements, Zero Energy Ready Home program requirements, and prevailing wage requirements for multifamily dwelling units.

III. Research Credit – Section 41

A. Overview

- 1. Section 41 (d) (1) provides four requirements that research activities must satisfy to constitute qualified research, the expenses of which may be eligible for the research credit:
  - The expenditures are eligible for treatment as specified research or experimental expenditures (SREs) under Section 174;
  - The activities must be undertaken to discover information that is technological in nature;
  - he activities must be intended to be useful in the development of new or improved business components (i.e., any product, process, computer software, technique, formula, or invention) intended for sale, lease, licensing, or use in one's trade or business; and
  - Substantially all of the activities must constitute a process of experimentation related to a new or improved function, performance, reliability, or quality.
- 2. In accordance with Section 41(d)(2), the four-part test must be applied to each individual business component separately.

A. Overview

- 3. Among the requirements for SREs under the first test above are that they be incurred during the tax year in connection with the taxpayer's trade or business and represent research and development costs "in the experimental or laboratory sense."

- 4. To be incurred "in the experimental or laboratory sense," the SREs must be intended to discover information that would eliminate uncertainty concerning a product's development or improvement (the uncertainty test). Uncertainty for this purpose exists if the information available to the taxpayer does not establish the capability or methodology for developing or improving the product or its appropriate design.

B. Adaptation Exclusion

- 1. Section 41 (d) (4) provides for various exclusions from the definition of qualified research. One exclusion is the adaptation exclusion that states in any research related to the adaptation of an existing business component to a particular customer's need or requirement is excluded from the definition of qualified research.

- 2. Activities related to adapting existing business component to fulfill the needs or specific requirements particular customer fall outside the purview qualify research and do not qualify for the credit.

Example

- **Betz v. Comm., TC Memo 2023 – 84**. The taxpayers were an S corporation that designed and supplied custom-built air pollution control systems. The systems were generally designed to meet specific customer needs and the taxpayer often purchase components the system from third-party suppliers and engage third-party subcontractors construct the systems. The taxpayer reported to research credit on its tax return related to 19 projects and calculated the credit based on wage and supply qualify research expenditures. The credit was allocated to the shareholders in their S Corporation. The Tax Court ruled in favor of the IRS holding the taxpayers were not entitled to the credit because the cost assisting the development activities did not meet the Section 174 uncertainty test and certain projects constituted funded research which is excluded from the qualified research definition. The court determined that conducting postproduction testing on a product is not establish that it's an appropriate design as a whole and remained uncertain before testing was completed. The court looked at the employees activities for the projects at issue and found the place had sufficient detail for the project to establish appropriate design that was not uncertain in nature. The court also determined that the expenditures incurred associate with the projects were excluded from qualified research under the adaptation exclusion rule because the comparable systems were produced design supplies and send customer such that the appropriate design the systems was already known and not uncertain from a technical nature.

IV. Qualified Commercial Clean Vehicle Credit

A. General

- 1. The Inflation Reduction Act of 2022 creates a new Section 45 W credit for qualified commercial clean vehicles (QCCV) acquired for use or lease by the taxpayer (not for resale).
- 2. The credit amount allowed with respect to the qualified commercial clean vehicle is equal to the lesser of:
- 15% of the basis of the vehicle (30% in the case of a vehicle not powered by a gasoline or diesel internal combustion engine); or the incremental cost of such vehicle.

B. Qualified Commercial Clean Vehicles Defined

- 1. A qualified commercial clean vehicle is any vehicle subject the allowance for depreciation (except for tax-exempt entities) that is:
  - Made by a qualified manufacturer;
  - Acquired for use or lease by the taxpayer and not for resale;
  - Treated as a motor vehicle for purposes of title II of the Clean Air Act and is manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails), or is mobile machinery as defined in §4053(8); and
  - Propelled to a significant extent by an electric motor which draws electricity from a battery which has a capacity of not less than 15 kilowatt hours (or seven kilowatt hours in the case of a vehicle with a gross vehicle weight rating of less than 14,000 pounds) and is capable of being recharged from an external source of electricity, or is a fuel cell vehicle.

C. Credit Limitation

- 1. The maximum credit for vehicles with a gross vehicle weight rating of less than 14,000 pounds is $7,500.

- 2. The amount increases to $40,000 for all other eligible vehicles. No credit is allowed unless the VIN (vehicle identification number) is included on the tax return.

- 3. The new credit applies to qualified commercial clean vehicles acquired after 2022 and before 2033.

D. Safe Harbor Provided for Credit – Notice 2024 – 5; IR 2023 – 245

- 1. The IRS has issued a notice regarding the commercial clean vehicle credit for vehicles placed in service in 2024.

- 2. The guidance provides a safe harbor for certain qualified commercial clean vehicles placed in service in calendar year 2024, which allows for reliance on the Department of Energy ("DOE") analysis of incremental costs.

- a. The analysis shows that the incremental cost of all street electric vehicles (other than in the case of compact car plug-in electric hybrids (PHEVs)) that have a gross vehicle weight rating of less than 14,000 pounds will be greater than $7,500 in calendar year 2024.

- 3. The incremental cost will not limit the available credit amount for street electric vehicles that have a gross vehicle weight rating of less than 14,000 pounds and are placed in service in calendar year 2024.

A. General

- 4. For compact car PHEVs hybrids placed in service during calendar year 2024, for which the incremental cost was calculated to be less than $7,500, the IRS will accept a taxpayer's use, when calculating the credit amount, of the incremental cost published by the DOE.

- 5. In addition, the DOE analysis provided an incremental cost analysis of current costs for several representative classes of street electric vehicles with a gross vehicle weight rating of 14,000 pounds or more. For those vehicles placed in service during calendar year 2024, the IRS will accept a taxpayer's use, in calculating the credit amount, of the incremental cost published by the DOE.

V. Final Regulations Prevailing Wage and Apprenticeship (PWA) requirements – TD 9998

A. Overview

- 1. The service has issued final regulations on the prevailing wage and apprenticeship (PWA) requirements allowing increase credit or deductions for certain energy initiatives established on the inflation reduction act.

- 2. The legislation provides increased credit or deduction amounts for taxpayers who satisfy certain PWA requirements regarding the construction, alteration, or repair of certain clean energy facilities or properties, projects, or equipment. Taxpayers can generally increase the base amount of the credit or deduction by five times when they satisfy the PWA requirements,

A. Overview

- 3. To qualify for the PWA increased credit or deduction amounts, the IRS said taxpayers generally need to:
  - Ensure employed laborers and mechanics are paid wages at rates not less than applicable prevailing wage rates;
  - Meet certain requirements related to employing qualified apprentices from registered apprenticeship programs; and
  - Meet specific recordkeeping and reporting requirements.

- 4. The PWA requirements apply to all contractors and subcontractors of the taxpayer that employ laborers and mechanics. However, taxpayers claiming the increased credit or deduction are responsible for ensuring that the PWA requirements are satisfied.

A. Overview

- 5. The IRS has released Publication 5983: IRA Preventing Way to Apprenticeship Requirements Fact sheet and have updated Publication 5855: Prevailing Wage and registered Apprenticeship Overview.

- 6. Prevailing wage rates are set by the Department of Labor for specific classification laborers or mechanics where the work is being performed.

- 7. Suspected violations can reporting IRS Form 3949.

- 8. The prevailing wage and apprenticeship requirements pertain to the following credits:

A. Overview

- Alternative Fuel Refueling Property Credit
- Production Tax Credit
- Investment Tax Credit
- Clean Fuel Reduction Credit
- Credit for Carbon Oxide Sequestration
- Credit for Production Clean Hydrogen
- Advanced Energy Project Credit
- Energy Efficient Commercial Building Deduction
- New Energy Efficient Home tech credit
- Zero Emission Nuclear Market production Credit

SECTION XIII:

C CORPORATIONS

I. Tax Rate and AMT

A. Current Corporate Tax Rate

- 1. The current corporate tax rate remains at 21%.

B. Corporate Alternative Minimum Tax

- 1. The Inflation Reduction Act imposes a new 15% corporate alternative minimum tax on the adjusted financial statement income of applicable corporations. (Section 55(b)(2), as amended by Act Sec. 10101(a)(1)). The Corporate AMT impose a 50% minimum tax on book income rather than taxable income on corporations with AF SI of more than $1 billion beginning after December 31, 2022.

- 2. The minimum tax will apply if it exceeds the taxpayer's regular tax including its base erosion and anti-abuse tax (BEAT) for the tax year. (Section 55(a)(2), as amended by Act Sec. 10101(a)(2) and Section 55(a)(3), as amended by Act Sec. 10101(a)(3))

- 3. The starting point of the calculation is a corporation's average annual adjusted financial statement income which includes financial statements prepared in accordance with generally accepted accounting principles (GAAP) as opposed to taxable income.

- 4. An applicable corporation for a tax year is any corporation, other than an S corporation, regulated investment company (RIC), or a real estate investment trust (REIT) which meets the average annual adjusted financial statement income test for one or more earlier tax years that ends after December 31, 2021. (Section 59(k)(1)(A), as amended by Act Sec. 10101(a)(2)).

B. Corporate Alternative Minimum Tax

- 5. A corporation meets the test if its average annual adjusted financial statement income for the three-tax-year period, determined without regard to loss carryovers, ending with the tax year exceeds $1 billion. (Section 59(k)(1)(B)(i), as amended by Act Sec. 10101(a)(2))

- 6. Adjusted financial statement income is the net income or loss of the taxpayer as presented in the taxpayer's applicable financial statements (defined under Section 451(b)(3)) for the tax year. (Section 56A(a), as amended by Act Sec. 10101(b)(1); Section 56A(b), as amended by Act Sec. 10101(b)(1)) The adjusted financial statement income for the group as a whole, takes into account the items on the group's applicable financial statement allocable to members of the group, only if the corporations file consolidated returns. (Section 56A(c)(2)(B), as amended by Act Sec. 10101(b)(1)) Adjusted financial statement income of a disregarded entity owned by the taxpayer is included in adjusted financial statement income but adjusted financial statement income of a partnership owned by the taxpayer is taken into account only to the extent of corporation's distributive share of adjusted financial statement income of the partnership. (Section 56A(c)(2)(D), as amended by Act Sec. 10101(b)(1))

B. Corporate Alternative Minimum Tax

- 7. There are tax adjustments made in determining adjusted financial statement income. A domestic corporation may take a corporate AMT foreign tax credit for the relevant foreign or U.S. possessions taxes that are taken into account on the corporation's applicable financial statement and paid or accrued (for tax purposes) by the applicable corporation. (Section 59(l)(1)(B), as amended by Act Sec. 10101(c))

- 8. The corporate general business AMT credit is limited to 25% of the taxpayer's net income tax exceeding $25,000. (Section 38(c)(6)(E), as amended by Act Sec. 10101(d))

C. Corporate AMT Proposed Regulations Issued – REG – 112129 – 23

- 1. The IRS issued proposed regulations addressing the application the corporate alternative minimum tax.
- 2. The service also issued a notice for the delay in the application the penalty for failure to pay estimated tax with respect to the corporate AMT.
- 3. he proposed regulations provide guidance on determining if a corporation is subject to the corporate AMT, including rules for members of a foreign-parented multinational group and the determination of the corporate AMT foreign tax credit.
- 4. The regulations also provide definitions and general rules for determining and identifying adjusted financial statement income (AFSI) and rules regarding certain statutory and regulatory adjustments in determining AFSI.
- 5. the proposed regulations address the application of the corporate AMT to affiliated corporations filing a consolidated income tax return.

D. Notice 2024 – 66 – Penalty Waiver

- 1. The IRS issued this notice which waives the county for corporation’s failure to pay estimated tax with respect to its corporate AMT for tax year beginning after December 31, 2023 and before January 1, 2025.

II. Dividend Received Deduction

A. Dividend Received Deduction – Section 243; US Domestic Corporation

- 1. Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations. The TCJA reduces the 70% dividends received deduction to 50%. The dividend received deduction for dividends received from a 20% owned corporation is reduced from 80% to 65%, effective for taxable years beginning after Dec. 31, 2017. Thus, the maximum rate on dividends received is 10.5% (50% of 21%). For controlled corporations, the maximum rate on dividends received is 7.35% (35% of 21%).

- 2. The above refers to domestic US corporations.

B. Foreign Corporations – Section 245A

- 1. For distributions made after Dec. 31, 2017, the TCJA allows an exemption for certain foreign income by means of a 100% deduction for the foreign-source portion of dividends received from specified 10% owned foreign corporations by domestic corporations that are US shareholders of those foreign corporations (referred to as a dividend received deduction (DRD).

B. Foreign Corporations – Section 245A

- A specified 10% owned foreign corporation (other than a PFIC that is not also a CFC) is any foreign corporation with respect to which any domestic corporation is a US shareholder.
- The term "dividend received" is intended to be interpreted broadly. For example, if a domestic corporation indirectly owns stock of a foreign corporation through a partnership and the domestic corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly, the domestic corporation is allowed a DRD with respect to its distributive share of the partnership's dividend from the foreign corporation.
- The DRD is available only for the foreign-source portion of dividends received by a domestic corporation from specified 10% owned foreign corporations.
- No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any
- portion of a distribution treated as a dividend that qualifies for the DRD.
- A domestic corporation is not permitted a DRD for any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend.

III. Final Regulations Issued for 1% Excise Tax on Corporate Stock Repurchases – TD 10002

A. Overview

- 1. The IRS released final regulations on the 1% excise tax on corporate Stock repurchases enacted under the Inflation Reduction Act of 2022.
- 2. The final regulations apply to publicly traded domestic corporations and certain publicly traded foreign partnerships that repurchase their stock or whose stock is acquired by certain affiliates after December 31, 2022.
- 3. The stock repurchase excise tax is required to be reported on Form 720: Corley Federal Excise Tax Return

B. Change from Proposed Regulation

- 1. The final regulations clarify that a stock repurchase excise tax must be filed with respect to any tax year in which the covered corporation a person is treated as a cover corporation make a repurchase or is treated as making a repurchase.

- 2. The final regulations clarify that regulated investment companies and real estate investment trusts are exempt from the obligation to file a stock repurchase excise tax return.

- 3. The final regulations were proposed to apply to stock excise tax returns required to be filed after the final regulations were published in the Federal Register and during tax years after that date.

IV. Repatriation Tax Constitutional

A. General

- 1. The US Supreme Court held that Section 965 transition tax which attributes realized undistributed income to US shareholders of controlled foreign corporations and taxes them on that income does not violate the U.S. Constitution. This was decided in the more decision

- 2. Background on Moore – 602 US_______________ (2024)

A. General

- The taxpayer bought 13% share of a controlled foreign corporation (CFC) in India. The company generating income however the CFC did not distribute the income to the US shareholder including the taxpayer. The couple did not reporting tax on the income. Section 965 imposes a one time transition tax on accumulated income of CFCs. The accumulated and undistributed income was attributed to the US shareholders and they are subject to tax. The income that should have been reported according the IRS was approximately $508,000 after deductions the couple had hundred and $32,500 in income subject to the tax resulting in an amount they owed of just under $15,000. The taxpayers argued that the section 965 taxes unconstitutional. The taxpayers argued that because they had not received any of the income from the CFC they had not realized any income. They argue the transition tax was an unconstitutional un-apportioned direct tax on their shares of stock in the CFC. The District Court dismissed the suit and the ninth circuit court held that the realization of income is not a constitutional requirement. The appeal to the US Supreme Court was to address the question of whether the 16th amendment authorizes Congress to tax unrealized some without apportionment among the states.

A. General

- The 16th amendment establishes that taxes on income, including property, need not be apportioned. The Supreme Court held that the transition tax was constitutional and was about exercise of congresses taxing authority. The taxpayers had contended that the transition tax is a tax on property not income and therefore the taxes unconstitutional because it is not apportioned. They reasoned that the income requires realization and they had not received the income therefore they had not realized any income. The Supreme Court stated that the tax does tax realized income and such income is realized by foreign corporation that has tax attributes to its shareholders which would include tax on their share of undistributed income.

V. Gross Income Issues

A. Treatment of Contribution of Capital – Section 118

- 1. The gross income of a corporation does not include any contribution to its capital (§118(a)). However, the TCJA provides that the term "contributions to capital" does not include:
  - any contribution in aid of construction or any other contribution as a customer or potential customer, and
  - any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

B. Corporate Reward Programs

- 1. Taxpayer who is a C corporation is required to include income revenue from its customer or member rewards program as a general rule irrespective of whether the funds are held by a trustee, agent or conduit.

- Example

- **Hyatt Hotels Corporation v. Comm., TC Memo 2023 – 122**. The Hyatt Corporation, its subsidiaries and parents are required to include income revenue from its customer/member rewards program even though said funds have been paid it have been accounted for by trustees, agents are conduits. The taxpayer argued that these reward programs are associate with different hotel owners, franchisees etc. and that the taxpayer requires third-party hotel owners to participate in the program and pay into the fund. The Hyatt controls the amount of payment and compensation they decide how the funds are invested they accrued interest and realize investment gain. They determine what particular advertising shall occur. There is no evidence to show a conduit or arrangement in which they are not in control and as such are required to include as other income.

VI. Reasonable Compensation

A. General Rule

- 1. Generally, determining if corporate payments to a shareholder/employee are salaries or dividends involves analyzing if the amount of the salary was reasonable and if the payment was purely for services.

- 2. Generally, the IRS limits deductions of compensation stating that they shall be allowed as a deduction all that are ordinary and necessary pain or incurred during the tax year in carrying on a trade or business including a reasonable allowance for salaries or other compensation for personal services actually rendered. (Section 162).

- 3. In determining whether payments are reasonable the service indicates that the amount is viewed reasonable if you would ordinarily be paid for like services by light Enterprises under like circumstances. (See Regulation 1.162 – 7 (b) (3)) to that end, the courts look at the following factors in ascertaining the reasonableness of compensation:

A. General Rule

- Employees role in the company,
- External comparisons with other companies,
- Character and Condition of the company,
- Internal consistencies and compensation, and
- Potential conflicts of hypothetical independent investors.

Example

- Clary Hood, Inc., v. Comm., TC Memo 2022-15. The Tax Court redetermined deductible amount of compensation which closely held construction co./taxpayer paid to CEO finding that taxpayer failed to adequately establish how amount it claimed for each year was both reasonable and paid solely as compensation for founder's services during stated time. Nonetheless, taxpayer was still entitled to deduct up to stated amounts, which were less than taxpayer claimed but more than IRS determined. Court noted that in this case, factors addressing comparable pay by comparable concerns, taxpayer's shareholder distribution history, how founder's compensation was set in years at issue, and his involvement in taxpayer's business were most relevant and persuasive factors in reaching its conclusion. Court also looked to expert who included compensation for surety bond guaranties in his analysis and provided well-reasoned salary comparison against industry standards. Also, taxpayer's arguments regarding using independent investor vs. multifactor test were rejected.

VII. Constructive Dividend

A. Rule

- 1. When a corporation makes a payment primarily for the benefit of a shareholder without expectation of payment, this payment may be construed to be a taxable constructive dividend if the payment is made with respect to the shareholder's stock in their capacity as a shareholder.

- 2. It is treated as another type of payment, such as compensation or payment for property, if it is not. The treatment of the distribution determines whether the shareholder has ordinary income, capital gain, or a tax-free return of capital and whether the paying corporation is, or is not, entitled to deduct the payment as an expense.

- 3. The following factors are used in determining whether a distribution is a constructive distribution:
  - Does the corporation perform services for the shareholder?
  - Does the corporation pay the shareholder's personal debts or expenses?
  - Does the corporation allow the shareholder to use corporate property for personal purposes?
  - Does the corporation make excessive payments to the shareholder for the use of property?
  - Does the corporation otherwise provide benefits to the shareholder?

Examples

- **Fabian v. Comm., TC Memo 2022-94**. Taxpayer/owner was charged with unreported income in form of constructive distributions made via transfers from his solely owned corp. to or through other controlled entities to him. Those transfers and entities included transfers to entity he used for beach house purchases, transfers to ostensible exempt org. that at least in part went to things like swimming pool construction account, and transfers to private jet co., all of which benefited taxpayer personally. And such constituted dividends includible in his gross income. His arguments that corp. lacked sufficient E&P to support dividend treatment failed in face of overall record and facts that corp., which taxpayer used in significant but phantom or fraudulent computer sales-leaseback transactions, had income therefrom that was likely considerable, "resulting in an equally considerable increase in earnings and profits." His attempt to now disavow form of those transactions was rejected.

Examples

- **Barrington v. Comm., TC Memo 2022 – 68**. Taxpayers had unreported income from corporate payments of the personal expenses such as mortgage on their home, furnishings, car payments. Taxpayers argued such payments were compensation and not constructive dividends because the payments were made in exchange for their services to the corporation. – Good luck with that argument!

A. Rule

- 4. IRS cannot perform a shortcut computation in calculating constructive dividends by subtracting allowable corporate deductions from total disbursements.

Example

- **Palmarini, Inc. v. Comm., TC Memo 2022 – 119**. The Tax Court redetermined the amount of constructive dividend income to the taxpayer from corporate payments of certain expenses associated with the president's personal benefit receiving from such payments. The court rejected the IRS's method of calculating dividends by subtracting allowable corporate deductions from the total distributions. This is not sufficient to meet the government's burden of production for connecting a corporate officer to unreported income. The IRS is required to establish the set pick expenses connected with the president and then show that the payments were of benefit to the president or corporate officer personally.

SECTION XIV:

S CORPORATIONS

I. Guidance on Perfecting S Elections and QSubs Elections – Rev. Proc 2022 – 19

A. Overview

- 1. The IRS released Rev. Proc. 2022-19, which expands Rev. Proc. 2013-30 providing a simplified method for taxpayers to request relief for late elections by S corporations, qualified Subchapter S subsidiaries (QSubs), electing small business trusts (ESBTs), and qualified Subchapter S trusts (QSSTs).

- 2. Rev. Proc. 2022-19 also amplifies Rev. Proc. 2004-35 providing automatic relief for certain taxpayers requesting relief for late shareholder consents for S elections in community property states.

- 3. In addition, Rev. Proc. 2022-19 adds certain no-rule areas with respect to IRS letter ruling requests, consistent with the guidance provided in the revenue procedure. The guidance focuses on six issues:
  - nonidentical governing provisions;
  - principal-purpose determinations regarding the one-class-of-stock requirement;
  - disproportionate distributions;
  - certain inadvertent errors or omissions on Form 2553, Election by a Small Business Corporation, or Form 8869, Qualified Subchapter S Subsidiary Election;
  - missing administrative or acceptance letters for an S or QSub election; and
  - the requirement to file returns consistent with an S election.

A. Overview

- 4. The governing provisions of an S corporation cannot provide for disproportionate distribution or liquidation rights among any shares of stock, or else the S corporation will have two classes of stock and will be ineligible to have an S election (See Regs. Sec. 1.1361-1(l)). This most often applies in the context of a limited liability company with an S election that has governing provisions more common to those of a partnership. These are known as non-identical governing provisions.

A. Overview

- 5. Rev. Proc. 2022-19 provides a new method for relief for nonidentical governing provisions. To qualify for relief, the S corporation and its shareholders must satisfy the following requirements:
  - The corporation has or had one or more nonidentical governing provisions;
  - The corporation has not made, and for federal income tax purposes is not deemed to have made, a disproportionate distribution to an applicable shareholder;
  - The corporation timely filed (defined as filed within six months after its original due date, excluding extensions) a return on Form 1120-S, U.S. Income Tax Return for an S Corporation, for each tax year of the corporation, beginning with the tax year in which the first nonidentical governing provision was adopted and through the tax year immediately preceding the tax year in which the corporation made a request for corrective relief; and
  - Before any nonidentical governing provision is discovered by the IRS, all of the requirements of the revenue procedure are satisfied.

A. Overview

- 6. To request relief, the corporation must prepare a statement of all the relevant facts, signed by a corporate officer, and each applicable shareholder must consent to the election. The corporation will prepare an explanation of how each nonidentical governing provision was discovered and each action taken to correct or remove it. To demonstrate reasonable cause for relief, the description must include each action taken by the corporation and each applicable shareholder to establish that the corporation and shareholder acted reasonably and in good faith in correcting or removing each nonidentical governing provision upon discovery.

- 7. Applicable shareholders include the corporation's current or former shareholders who own or owned stock of the corporation at any time during the period beginning on the date on which the nonidentical governing provision was adopted and ending on the date on which the nonidentical governing provision was removed or modified to comply with the one-class of- stock requirement.

A. Overview

- 8. The corporation will retain the corporate governing provision statement, the shareholder statement(s), and the revised governing provisions in its corporate records. There is no need to notify the IRS of the corporation's identification of the nonidentical governing provisions, the change in governing provisions, or the qualification for relief under Rev. Proc. 2022-19. Rather, if the IRS examines the corporation, then the corporation will provide the documentation to support meeting the requirements for relief under the revenue procedure.

A. Overview

- 9. To perfect the Form 2553 or Form 8869, the taxpayer must write to an IRS service center explaining the error(s) or omission(s) and the necessary correction(s). Note that Rev. Proc. 2022-19 provides specific addresses where the request should be mailed, which differ from where a Form 2553 or Form 8869 is currently filed.

- 10. When a taxpayer files Form 2553 for an S election or Form 8869 for a Qsub election, the IRS will provide a written acknowledgment of its acceptance (CP261 for an S election; for a Qsub election, CP279 to the parent and CP279A to the subsidiary). The written acknowledgment is an administrative item that does not affect the election. A new letter can be requested by calling the IRS. A letter ruling is not available with regard to any missing administrative acceptance letter.

- 11. Rev. Proc. 2022-19 verifies that filing an incorrect income tax return (e.g., Form 1065, U.S. Return of Partnership Income, or Form 1120, U.S. Corporation Income Tax Return) inconsistent with an S or Qsub election does not by itself terminate the validity of the S or Qsub election. The revenue procedure provides that the taxpayer must file a federal income tax return for open tax years consistent with its status. (Note that, depending upon the type or return filed and the facts and circumstances surrounding the filing, the statute of limitation may not have started.) The IRS will not issue a letter ruling to address any inconsistent return filing.

II. S Corporation Election; Section 1361 (b) – Requirements

A. Update

- 1. To become an S corporation and organization must be a small business corporation which requires all of the following to be met:
  - The entity must be a domestic corporation organized under the laws of the United States or US territory or domestic eligible entity that elects to be taxed as a corporation under the check the box rules (See Reg. Sec. 1.1361 – 1 (c); 301.7701 – 3)
  - The Corporation may have shareholders who are only individuals, states, certain trust, banks and certain exempt organizations. Partnerships and corporations cannot be shareholders.
  - Only US citizens or resident aliens can be shareholders.
  - The corporation can have only one class of stock.

- 2. Form 2553- Election to Be S Corporation

A. Update

- a. An S election is effective for the current year if it is filed on or before the fifteenth day of the third month of that year.
- b. Elections made after that date are effective for the following year.
- c. Each shareholder who owns (or is deemed to own) stock at the time the election is made must consent to the election. Signers include a spouse with a community property interest.
- d. Form 2553 can be filed with Form 1120-S

B. Digital Access Question

- 1. For 2023 and beyond the digital asset question will be added to all pass-throughs, including estates and trusts.

C. Late S Corporation Elections - Rev. Proc. 2013-30

- 1. The IRS has announced simplified methods for taxpayers to request late S corporation elections by consolidating and expanding earlier guidance. The exclusive simplified methods are also available to taxpayers requesting relief for late Electing Small Business Trust (ESBT) elections, Qualified Subchapter S Trust (QSST) Elections, Qualified Subchapter S Subsidiary (QSub) elections, and certain late corporate classification elections.

- 2. The requesting entity may request relief for a late election by properly completing the election form and attaching supporting documents as applicable.

- 3. The requesting entity may attach the election form to the S corporation's current year Form 1120S, to one of the S corporation's late filed prior year Forms 1120S, or file the election independent of Form 1120S.

C. Late S Corporation Elections - Rev. Proc. 2013-30

- 4. Among other requirements, the requesting entity must include a statement describing its reasonable cause for failure to timely file the election, as well as describing its diligent actions to correct the mistake upon discovery.

- 5. The election form must state across the top “Filed Pursuant To Rev. Proc. 2013-30.”

- 6. A requesting entity is a corporation (or an eligible entity to which a Deemed Entity Classification Election will apply) seeking to be treated as an S corporation, a trustee seeking to treat a trust as an ESBT, a trust beneficiary seeking to treat a trust as a QSST, or a parent seeking to treat a subsidiary as a QSub.

C. Late S Corporation Elections - Rev. Proc. 2013-30

- 7. An entity that fails to satisfy, or is denied relief under, Rev. Proc. 2013-30, may seek relief by requesting a letter ruling.

- 8. Rev. Proc. 2013-30 also provides specific requirements for requesting entities seeking relief for late S corporation elections (which may or may not include a Deemed Entity Classification Election) (Section 5); late ESBT and late QSST elections (Section 6); and late QSub elections (Section 7). Additionally, the IRS provided supplemental procedural requirements when seeking relief for multiple late elections.

D. Revoking S Election

- 1. Section 1362 describes the procedures for electing or revoking S corporation status. It also states some rules for terminating S corporation status if the corporation fails to meet one or more of the eligibility requirements of Sec. 1361.

- 2. Section 1362(g) restricts S corporations for which the S election has been terminated from reelecting S corporation status before the fifth tax year after the year of termination, unless the IRS consents to a new election.

- 3. Certain relief under this section requires a taxpayer to submit a request for a Private Letter Ruling. However, taxpayers considering a letter ruling for inadvertent termination will need to now follow Revenue Procedure 2022 – 19.

- 4. Does a bankruptcy have an impact on the revocation of an S election?

Example

- **In Re Vital Pharmaceuticals (Bktcy Ct FL) 132AFTR2d 2023 – 5268**, a bankruptcy court rejected a sole shareholders request for leave from automatic stay in his S corporations Chapter 11 bankruptcy case where the shareholder was attempting to revoke the S election and thus ultimately shifting back to the Corporation the tax liability on a $370 million asset sale. The bankruptcy court determines the S election was property of the bankruptcy estate and as such the S election was protected by the automatic stay. The shareholder received tax benefits from the S election for a number of years prior to the filing of the bankruptcy could not show cause for lifting the stay or even if the shareholder taxpayer could the relief would be null and void because it was the corporation that made the S election or it's the corporation that will determine if it will be revoked. The court went on to note that although the shareholder did have a role of consenting to the election or revoking the election this did not mean that there is no distinction between a corporation and shareholders particularly whereas here the shareholder wasn't not in fact an officer or director and their interest in duties were not aligned.

III. Issues Involving Second Class of Stock

A. General Rule

- 1. An S corporation cannot have more than one class of stock (See Section. 1361(b)(1)(D)). For this purpose, a corporation is treated as having one class of stock if all outstanding corporate shares of stock confer identical rights of distribution and liquidation proceeds. Differences in voting rights are disregarded.(See Section 1361(b)(1)(D) and Reg. 1.136 – 1(l)(1)).

- 2. The determination of whether all outstanding shares meet this condition is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the "governing provisions"). Commercial agreements, such as contractual agreements, leases, and loan agreements, are not governing provisions unless a principal purpose of an agreement is to circumvent the one-class-of-stock requirement.

- 3. Certain instruments are not treated as a second class of stock such as obligations, or arrangements including: many call options; certain short-term unwritten advances and proportionately held debt; straight debt; certain buy-sell and redemption agreements; and certain deferred compensation plans. (See Reg. 1.1361 – 1 (l) (4) and (5))

B. Risk of Termination

- 1. LLC electing S Corp. Status. Does an LLC that elects S Corp. status just have one class of stock under Section 1361.

B. Risk of Termination

- IRS Letter Ruling 202110010. The IRS in this letter ruling examined whether the LLC electing S Corp. status has one or more classes of stock or equity. The determination and focus was on the LLCs operating agreement as to whether it created a 2nd class of stock. In examining the operating agreement, it included partnership provisions that apply regardless of whether the entity was a partnership or an S corporation. For example, one part of the operating agreement indicated in the event the LLC is to be liquidated under the provisions of Section 1.704 – 1 (b) (2) (ii) (g) then liquidating distribution shall be made to the members have positive capital accounts in compliance with Section 1.704 – 1 (b) (2) (ii) (b) (2). The service determined that the terms the operating agreement created a 2nd class of stock for the S corporation. The IRS position is that the mere existence of the language of the operating agreement causes the termination of the S Corp. It is thus important from a planning perspective to look at operating agreements and remove disproportional language.

B. Risk of Termination

- IRS Letter Ruling 202142003. In this letter ruling, the IRS examined an LLC operating agreement and determined a 2nd class of stock existed. The operating agreement included provisions regarding the allocation of profits among members in proportion to their negative capital account balances, if any, the allocation of losses among members in proportion to positive capital account balances and the requirement that any liquidation distributions would be in proportion to capital account balances. Again, the entity’s intent was to be an S Corp. from day one because the language was included in their service took the position that it was a termination.

B. Risk of Termination

- 2. Conversion in Addition of New Owner Resulting in The eligible Shareholder and 2nd Class of Stock.
  - PLR 202322009. An S corporation used state law and converted to become a state law limited partnership. Immediately after the conversion the new entity file Form 8832 to make the conversion a Type F Reorganization. The former corporations S Corporation status continued to be in effect. At the time of the conversion, the entity had only one shareholder. On the same date as the conversion, the entity issued ownership units to a partnership. The conversion and the new member violated shareholder eligibility and the single class of stock rule. The new owner, a partnership was able to convert to a disregarded entity whose members was eligible to hold S Corporation Shares. The former S Corporation turned limited partnership converted again to an LLC. The Service permits a corporation retained its S status on the condition the entity and its owners file returns as well as amended returns which reported the S corporation items properly.

B. Risk of Termination

- 3. Second Class of Stock Involving Qualified Opportunity Fund Election – Regs 1.1400Z2(b) – 1(c)(7)(iv)

- a. This regulation addresses an S corporation operating a mixed-funds investment in a QOF. Under the regulation, if different blocks of stock are created for separate qualifying investments to track basis in such qualifying investments, the separate blocks are not treated as different classes of stock for purposes of S corporation eligibility under Sec. 1361(b)(1).

C. Non Risk Issues

- 1. Employee stock compensation not second class of stock - PLR 201918013

- a. In a Private Letter Ruling (PLR), IRS has concluded that an S corporation’s employee stock compensation plan did not create a second class of stock. The transfer and repurchase restrictions on the plan's shares were disregarded when determining whether the shares awarded under the plan had identical rights to other stock issued by the S corporation.

- b. The taxpayer, an S corporation, adopted an employee stock compensation plan that authorized the corporation to sell shares of its stock to key employees or to grant shares or options to purchase shares to such employees.

C. Non Risk Issues

- c. Shares acquired under the plan were subject to certain restrictions; they could not be transferred without the prior written consent of the taxpayer's Chairman of the Board, and the corporation could repurchase the shares under certain circumstances, for example upon termination of employment, at fair market value or the forfeiture repurchase price.

- d. The transfer restrictions and repurchase provisions were disregarded when determining whether the plan's shares confer identical rights to other stock issued by the S corporation. The transfer restrictions and repurchase provisions were bona fide agreements to redeem or repurchase stock under Regulation Section 1.361 – 1(1)(iii)(2)(B).

D. Inadvertent Termination Issues

- 1. If an S corporation fails to maintain its status as a "small business corporation" under Section 1361(b), its S election automatically terminates on the date the disqualifying event occurs.

- 2. The disqualifying events that can terminate S status include the following (Sections. 1362(d)(2) and 1361(b)(1); Regs. Sec. 1.1362-2(b)(1)):
  - Having more than 100 shareholders. The S corporation can have more than 100 shareholders in total during the year as long as there are no more than 100 shareholders at any given time.
  - Having an ineligible shareholder (e.g., a corporation, partnership, ineligible trust, or nonresident alien). Partnership and corporate shareholders generally are not permitted, other than so-called transitory ownership as part of a corporate reorganization.
  - Having more than one class of stock. Differences in voting rights are allowed, which can be useful, for example, when transferring nonvoting common stock to younger family members or trusted employees.
  - Becoming an ineligible corporation such as an insurance company or a domestic international sales corporation.
  - Transferring place of incorporation to a foreign country (thus no longer qualifying as a domestic corporation).

D. Inadvertent Termination Issues

- 2. What is not considered a termination?
- a. Using Impermissible Tax Year. It The IRS in technical Advice Memorandum 9505003stated that a corporation's S election was not terminated by using an impermissible tax year .
- b. State Administrative Dissolution. The IRS in Letter Ruling200835002 has stated in a corporation that qualified as an S corporation prior to estates administrative dissolution when the corporation failed to file an annual state report or franchise tax report is not required to file a new S election. That is not an inadvertent termination. Likewise, an S corporation that did not know he had been administratively dissolved for nonpayment estate fees is not required to file tax election under Letter Ruling 201237001.

D. Inadvertent Termination Issues

- c. Bankruptcy Filing. A bankruptcy estate is an eligible S corporation shareholder under either Chapter 7 or 11 he does not cause the S election to terminate. (See In Re Bakersfield Westar, 226 BR 227 (9th CIR 1998).

- d. When can an inadvertent termination occur? As a general rule, there is not an exclusive list of factors that cause the S Election to terminate. Some ways that an inadvertent termination can occur include the following:

D. Inadvertent Termination Issues

- i. A successor beneficiary of a qualified Subchapter S trust (QSST) affirmatively refuses to consent to the original QSST election, which means the QSST is no longer an eligible S corporation shareholder;

- ii. The S corporation stock is pledged as collateral for a personal loan and, upon default, is acquired by an ineligible shareholder pursuant to a foreclosure sale (See IRS Letter Ruling 9138025);

- iii. An S corporation that has accumulated earnings and profits (AE&P) receives more than 25% of its gross receipts from passive investment income in three consecutive years; or

D. Inadvertent Termination Issues

- iv. A shareholder dies, and the estate holds the S corporation stock for more than two years (See Regs. Sec. 1.1361-1(h)(3)(i)(B)).

- v. Missing a QSST or ESBT election within the timeframe the IRS provides.. Rev. Proc. 2013 – 30 does allow relief to be obtained for a late election.

- d. Failure to obtain required shareholders consent and trust becoming an ineligible shareholder upon trustees failure to file ESBT election for trust are considered inadvertent in nature. The entity will continue to be an S corporation from the stated date and thereafter provided its election was not otherwise terminated. The ruling was contingent on shareholders folly consents and trustee find the ESP to election within hundred 20 days of the date of the Private Letter Ruling. (PLR 202322011)

D. Inadvertent Termination Issues

- e. Termination of S Corp. Election to trust becoming ineligible shareholder was inadvertent. The S Corp. would continue to be treated as such from the stated date and thereafter provided the election was valid and not otherwise terminated. This was a socio-the cute SST election not being timely filed. (PLR 202322018)

IV. S Corporation
Tax Year

A. General

- 1. Under Sec. 1378, the tax year of an S corporation must be a permitted year. A permitted year is the calendar year, a valid tax year elected under Sec. 444, a 52—53-week tax year ending with reference to the required tax year or a tax year elected under Sec. 444, or any other accounting period for which the corporation establishes to the satisfaction of the IRS a "business purpose."

- 2. Expediting refund not a valid business purpose to change accounting period

A. General

- a. In Chief Counsel Advice (CCA) 202141023, the IRS decided that an inquiry by an S corporation exploring the possibility of obtaining a "refund sooner than usual" by changing its accounting period was not a "viable solution." Because the taxpayer already had a Dec. 31 year end, the taxpayer would need to change to some other accounting period but would need to establish a business purpose that would satisfy the IRS as required under Sec. 444 and the regulations thereunder.

- b. The CCA cited Rev. Proc. 2006-46, which provides the exclusive procedures for obtaining automatic approval to adopt, change, or retain an annual accounting period by various types of taxpayers including S corporations. Specifically, the pertinent section of the revenue procedure (§2.01(3)(c)) provides:

A. General

- Sec. 1378 and § 1.1378-1(a) provide that the taxable year of an S corporation must be a permitted year. The term "permitted year" means (1) the required taxable year (i.e., a taxable year ending on December 31), (2) a taxable year elected under § 444, (3) a 52—53-week taxable year ending with reference to the required taxable year or a taxable year elected under § 444, or (4) any other accounting period for which the corporation establishes to the satisfaction of the Commissioner a business purpose.

- c. The Chief Counsel took the position here that a change in accounting period simply to get a refund sooner than usual (even recognizing the sympathetic nature of this case) was not a business purpose that would satisfy the IRS.

V. Passthrough of Items to Shareholders – IRC Section 1366

A. General Rule

- 1. Section 1366 provides that shareholders include their ratable share of separately and nonseparately stated items for the tax year on a per share, per day basis, whether or not any income is actually distributed. Tax-exempt income is among the separately stated items. Generally, ordinary and necessary business expenses paid by the S corporation, including state and local taxes and employee compensation to shareholders, are deducted against nonseparately stated items of income and pass through to the shareholder(s) as net ordinary income or loss.

Example

- **Maggard v. Comm., TC Memo 2024 – 77.** The S Corporations income flow to a married couple who were it shareholders and the S corporation was not subject to taxation as a C Corporation. The taxpayers contended that other shareholders of the S Corporation made unauthorized distributions to themselves in excess of their ownership shares. As such these actions terminated the S Corporation Status. The IRS argued that the other shareholders actions did not matter the regulations indicate that shareholders rights focus on governing documents and not what shareholders actions do. The disproportionate distributions are not enough to change the S Corporation status. The entity continue to have one class of stock the S Corporations entity neither authorized nor created a second class of shares by way of a formal corporate governance action. The taxpayers were required to include in their income allocable share of income from the K-1 despite any disproportionate distributions.

A. General Rule

- 2. Taxpayer shareholder still required to recognize her share of S Corporation Income even though taxpayer was excluded from the benefits of owning stock.

- **Veeraswamy v. Comm TC Memo 2024 – 83**. The taxpayer owned more than 50% of an S corporation that she began with her ex-husband. She had to recognize her share of the net income even though she was excluded from the benefits of owning stock by her former husband. She was still deemed to be a shareholder. A poor relationship between shareholders does not grant evasion of the recognition of pastor items or ownership treatment. Evidence indicated the taxpayer owned 50% interest corporate documents demonstrate such.

VI. Basis and Loss

A. General

- 1. S Corporation Shareholders are subject to the following loss limitations on deductions:
  - Basis in Stock limitations
  - Basis in Debt Limitations
  - Act Risk Limitations
  - Passive Activity Loss Limitations.

- 2. Losses flow to the shareholder taxpayer as a general rule. However, losses from an S corporation are deductible only to the extent of the shareholders basis of stock and any loans the shareholder makes to the corporation. In other words it is a basis of stock and basis of that issue.

A. General

- 3. If the shareholders losses and deductions reduce his or her basis of both stock and debt, the shareholder cannot take any losses. The disallowed losses are carried over into later years and are deductible if the basis or stock becomes positive this is pursuant to Section 1366 (d).

- 4. To determine the adjusted basis of a shareholders stock or debt, the shareholders basis must be determined. If stock was purchased, the basis generally its cost. If money was loaned to the S corporation, the basis is generally the amount of the loan. If a shareholder receives stock and S corporation in exchange for property, the basis in the stock is joy the same as his or her basis was in the property transferred.

B. Basis in Stock

- 1. The IRS plans to release a form to calculate basis of stock S corporation. It appears such will be used for the 2023 tax filing season. The IRS has put the following schematic of a worksheet on its website in determining basis of stock in an S corporation.

- 2. In computing stock basis, the shareholder starts with their initial capital contribution to the S corporation or the initial cost of the stock they purchased (the same as a C corporation). That amount is then increased and/or decreased based on the pass-through amounts from the S corporation. An income item will increase stock basis while a loss, deduction, or distribution will decrease stock basis.

- 3. A shareholder's stock is increased by the following:

B. Basis in Stock

	Schedule K-1
1. Ordinary income	Box 1
2. Separately stated income items	Boxes 2 – 10
3. Tax exempt income	Boxes 16A & 16B
4. Excess depletion	Box 15C

B. Basis in Stock

- 4. A shareholder's stock basis is decreased, but not below zero, the following:

B. Basis in Stock

	Schedule K-1
1. Ordinary loss	Box 1
2. Separately stated loss items	Boxes 2 - 12O and 14P, 14Q
3. Nondeductible expenses	Box 16C
4. Non-dividend distributions	Box 16D
5. Depletion for oil and gas	Box 17R

B. Basis in Stock

- 5. Only non-dividend distributions reduces stock basis, dividend distributions do not. The corporation is responsible for telling the shareholder the amount of non-dividend and dividend distributions. Box 16D of Schedule K-1 reflects non-dividend distributions. Form 1099-DIV is used to report dividend distributions; dividends are not reported on the shareholder's Schedule K-1.

- 6. Most distributions from an S corporation are non-dividend distributions. Dividend distributions can occur in a company that was previously a C corporation or acquired C corporation attributes in a non-taxable transaction (i.e., merger, reorganization, QSub election, etc.).

A. General

- 7. The order in which stock basis is increased or decreased is important. Because both the taxability of a distribution and the deductibility of a loss are dependent on stock basis, there is an ordering rule in computing stock basis. Stock basis is adjusted annually, as of the last day of the S corporation year, in the following order:
  - Increased for income items and excess depletion;
  - Decreased for distributions;
  - Decreased for non-deductible, non-capital expenses and depletion; and
  - Decreased for items of loss and deduction.

- 8. When determining the taxability of a non-dividend distribution, the shareholder looks solely to his/her stock basis (debt basis is not considered). For loss and deduction items, which exceed a shareholder's stock basis, the shareholder is allowed to deduct the excess up to the shareholder's basis in loans personally made to the S corporation. Debt basis is computed similarly to stock basis but there are some differences.

A. General

- 9. If a shareholder has S corporation loss and deduction items in excess of stock basis and those losses and deductions are claimed based on debt basis, the debt basis of the shareholder will be reduced by the claimed losses and deductions. If an S corporation repays reduced basis debt to the shareholder, part or all of the repayment is taxable to the shareholder.

C. Form 7203

- 1. Form 7203 replaces the three-part worksheet for figuring a shareholder stock and debt basis.

- 2. The form is filed by shareholders who:
  - Claimed the deduction for their share of aggregated loss from an S Corporation
  - Receiving nondividend distribution
  - Disposed of stock in an S Corporation regardless of whether or not they recognize gain or loss
  - Received a loan repayment from the S Corporation.

- 3. Likewise, Form 7203 is required for shareholders if they are claiming a loss or have distributions in excess of basis.

C. Form 7203

- 4. The form was expanded to ask questions as to how the stock was acquired,; was the taxpayer acquiring it as an original shareholder, by purchase, inheritance, gift or in some tax-free exchange. The form also requires disclosure of debt basis.

- 5. The IRS's position assumes for purposes of the shareholder's basis computation that the loss or deduction item is properly limited to the shareholder's stock and debt basis. Then in a subsequent year, when the shareholder has basis, the shareholder's basis is reduced by any loss or deduction previously taken in excess of basis. The IRS relies on Sec. 6214(b), which allows facts from closed statute years to be considered in computing the current-year computation of tax items, and Regs. Sec. 1.1016-6(a), which provides that adjustments to basis must always be made to eliminate double deductions or their equivalent, to reduce basis in the current open year for items that were improperly claimed in a prior tax year. The shareholder is precluded from claiming the loss a second time when the basis is reduced, under the principles of estoppel (Regs. Sec. 1.1016-6(b)).

C. Form 7203

- 6. The IRS provides that the losses in excess of basis from closed statute years must reduce basis in the open statute year after considering the positive adjustments to basis but before considering nondividend distributions; nondeductible, noncapital expenses; and any other loss and deduction items.

Example

- Moe is the 100% shareholder of S Corp. In year 1, the Corp had $50,000 in capital losses, and Moe had an adjusted basis of $20,000 in his stock. On his individual income tax return for year 1, he deducted the entire $50,000 capital loss and reduced his basis in his Corp stock to zero. In year 2, the Corp had an ordinary loss of $30,000. On his tax return for year 2, he deducted the $30,000 ordinary loss and claimed that his adjusted basis remained at zero. In year 3, the Corp had $90,000 of ordinary income. In year 3, Moe reported his share of Corp's income and increased the basis in his Corp stock by this income. In year 4, the Corp had $10,000 of long-term capital gain income, and he received an ordinary loss of $75,000. His year 1, year 2, and year 3 tax years are now closed under the statute of limitation for assessment. Year 4 is open under the statute of limitation.

Example

- Moe's basis at the beginning of year 4 is $30,000, computed under the normal stock basis ordering rules as if the shareholder had properly limited his loss and deduction items to stock basis. However, he can may report that his basis at the beginning of year 4 is $90,000, relying upon the statute of limitation on assessment being closed for year 1, year 2, and year 3.

- To account for the differences in basis computations, the IRS will begin year 4 with $90,000 of beginning stock basis and add the $10,000 of year 4 long-term capital gain, increasing Moe's stock basis to $100,000. His stock basis is then reduced by the $60,000 of prior-year losses in excess of basis from closed statute years. This allows A to report a $40,000 ordinary loss, and he must suspend the remaining $35,000 of ordinary loss until he has basis in a future year.

C. Form 7203

- 7. If a shareholder has a loss in excess of basis from a closed statute year and the shareholder sells his or her stock, the IRS does not require the shareholder to report more gain than would otherwise be required.

Example

- Moe is the 100% shareholder of S Corp. He has $100,000 of losses in excess of basis from closed statute years. If he sells his stock for $300,000, he will not report a $400,000 gain as would happen if the loss in excess of basis from closed statute years were negative basis. Moe still reports a $300,000 capital gain, and the remaining $100,000 of losses in excess of basis from closed statute years effectively disappears due to the statute of limitation.

C. Form 7203

- 8. The IRS has not provided guidance on whether the basis adjustment occurs in the year the loss should have been reported or in the first tax year with an open statute of limitation. The timing of when the adjustment to basis for losses in excess of basis from closed statute years is included in the basis computation affects the amount of beginning basis in the open statute year.

- 9. The IRS has not provided guidance on the treatment of nondividend distributions in excess of stock basis that were not reported as capital gains in a closed statute year. If nondividend distributions in excess of stock basis were not reported as capital gains, then it is unclear whether there is a basis adjustment similar to losses in excess of basis from closed statute years or if the statute of limitation on assessment precludes any current-year basis adjustment.

A. General

- 10. The IRS has also not provided guidance on the treatment if a shareholder fails to report the gain on loan repayment in a closed statute year when the loan is repaid in full in the closed statute year. Once again, the requirement to report gain in a closed statute year may preclude an adjustment to the current-year basis under the statute of limitation for assessment.

D. Basis in Debt – TD 9682

- 1. The IRS released final regulations relating to when shareholders have basis in debt that the S corporation owes to the shareholder, basis of debt)
- 2. The final regulations provide that basis of debt of the S corporation to the shareholder means the shareholder's adjusted basis in any bona fide debt of the S corporation that runs directly to the shareholder.
- 3. The final regulations do not apply the actual economic outlay standard, but instead provide that shareholders receive basis of indebtedness if it is bona fide debt of the S corporation to the shareholder. Whether the debt is bona fide debt to a shareholder depends upon all of the facts and circumstances (See §1.1366-2(a)(2)(I)).
- 4. With respect to guarantees, the final regulations retain the economic outlay standard by adopting the rule in the proposed regulations that S corporation shareholders may increase their basis of debt only to the extent they actually perform under a guarantee (See §1.1366-2(a)(2)(ii)).

Examples

- John is the sole shareholder of 2 S corporations S 1 and S 2. S1 loaned $200,000 to John. John then loaned the $200,000 to S 2. If John's loan to S2 meets the definition of being a bona fide debt from S 2 to John, John's loan increases is basis of debt in S 2. This is an example of a back to back loan.

- John is the sole shareholder of 2 S corporations S 1 and S 2. S 1 made a loan to S 2. S 1 assigned its creditor position in the note to John by making a distribution of the note to John. Under state law, after S 1 distribute the note to John, S2 was relieved of its liability to S 1 and was directly liable to John. Again, if the note constitutes a bona fide debt from S2 to John, the note increases is basis of debt. This is an example of a loan restructuring via a distribution.

Examples

- John is a shareholder of ABC Corporation. ABC Corporation is an S corporation. The corporation received a loan from Bad Bank. The bank required John guarantee as a condition of making the loan to ABC. In the following year, ABC could no longer make the payments on the loan. John made the payments directly to the bank from his personal funds until the obligation was satisfied. For each payment he made on the note, he receives basis of debt. This basis of debt was increased by the payments he made to the bank pursuant to the personal guarantee.

Examples

- 5. Indirect borrowing, such as acting as a surety or guarantor on corporate debt, generally does not result in basis-producing debt until the shareholder is required to pay as a result of the guarantee. Even when a shareholder is primarily liable on corporate debt to a third party, this debt will not qualify as "debt of the corporation to the shareholder." although the 11th Circuit Court of Appeals has held that a shareholder guarantee of a loan made to an S corporation may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligator (See Edward. M. Selfe, 86-1 USTC ¶9115).

E. Distribution in Excess of Basis

- 1. The typical rule for entities without accumulated earnings and profits is that distributions are not included in a shareholder's gross income to the extent that they do not exceed the adjusted basis of stock.

- 2. Any distribution amount in excess of basis is treated as gain from the sale or exchange of property.(See Section 1368(b).

Example

- **Hacker v. Comm., TC Memo 2022-16,** IRS's determination that married taxpayers had distributions in excess of basis from their solely owned S corp. was rejected. IRS failed to account for certain properties which taxpayers contributed to S corp. when computing basis and made other miscalculations or "misreading[s]" in computing its results.

F. S Corp. Shareholder can Claim Losses Based on Holding that Transfers Interest between closely Own Businesses – Debt versus Equity and Impact on Basis

- 1. Section 385 deals with the tax treatment of certain interest in corporations as either stock or debt. Specifically, Section 385 (c) states that the characterization at the time of the issuance by the issuer as to whether an interest in a corporation's stock or indebtedness shall be binding on the issuer and all holders of such interest. However, this does require the issuance of the instrument, be it debt or equity to be formally issued.

- 2. In the alternative, the courts have examined various factors as to whether a transaction is debt versus equity. Specifically, the court has applied various factors under the factors to determine whether the transfers from a corporation could be considered constructive distributions to a shareholder, followed by capital contributions . (See Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987))

F. S Corp. Shareholder can Claim Losses Based on Holding that Transfers Interest between closely Own Businesses – Debt versus Equity and Impact on Basis

- 3. The factors utilized in Hardman v. United States that the court examines include the following:
  - the names given to the certificates evidencing the indebtedness;
  - the presence or absence of a maturity date;
  - the source of the payments;
  - the right to enforce payment of principal and interest;
  - participation and management;
  - a status equal to or inferior to that of regular corporate creditors;
  - the intent of the parties;
  - "thin" or adequate capitalization;
  - identity of interest between creditor and stockholder;
  - payment of interest only out of "dividend" money;
  - the ability of the corporation to obtain loans from outside lending institutions

Example

- Estate of Thomas H. Fry et al. v. Comm., T.C. Memo. 2024-8. Thomas H. Fry was the sole shareholder of two S corporations, Crown Disposal, Inc. (Crown) and CR Maintenance Services, Inc. (CR Maintenance), which engaged in waste collection and waste processing, respectively. The management of both companies was extremely integrated, and they shared common facilities in Sun Valley, California. Beginning in 2010, CR Maintenance was not profitable and required regular cash infusions to stay in operation, which were provided by Crown at the direction of Mr. Fry and totaled approximately $36.25 million by the end of 2013 (the Transfers and Payments). Crown and CR Maintenance executed no promissory notes for any of the transfers, and there was no written due date for return of the money. No security interest was requested by Crown or granted by CR Maintenance. Furthermore, CR Maintenance did not make, or promise to make, interest payments related to the Transfers and the Payments.

Example

- The payments were characterized on CR Maintenance's balance sheet and tax returns from 2010 to 2019 as liabilities to Crown and not additional capital contributions from Mr. Fry. The Tax Court found that, from 2010 through 2020, "CR Maintenance reported the Transfers and the Payments as a balance due to Crown on its tax returns and characterized them as debts." For the 2013 tax year, CR Maintenance showed an approximately $5.65 million ordinary loss, of which the Frys claimed a $4.7 million flow-through loss on their individual tax return. In September 2020, the IRS issued the Frys a notice of deficiency disallowing approximately $3.46 million of the 2013 flow-through loss, saying the Frys lacked sufficient basis in CR Maintenance because the transfers from Crown were debt and not equity.

Example

- The Frys claimed in their petition to the Tax Court that the payments were constructive distributions from Crown, followed by equity contributions to CR Maintenance, regardless of how they were characterized on the balance sheets and tax returns of the two companies. The IRS in turn claimed that IRC Section 385(c), the duty of consistency, and the doctrine of election prohibited the Frys from recharacterizing the payments as equity when they previously characterized them as debt.

- The court first addressed the IRS's contention that IRC Section 385(c) bound the Frys to their characterization of the Transfers and Payments as debt at the time of filing their return for the 2013 tax year. IRC Section 385(c)(1) provides that "[t]he characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)." The court held that the IRC Section 385(c) requirement binding a taxpayer to its characterization of an instrument as debt or equity at issuance did not apply where an instrument was not formally issued.

Example

- In response to the Frys' secondary argument that IRC Section 385(c) does not apply to S corporations, the court noted in a footnote that no court decision had ever bound any taxpayer (S corporation or otherwise) to its initial characterization of an interest under IRC Section 385(c)(1). As a result, the court declined to apply IRC Section 385(c)(1), noting that "the ultimate test" is "not necessarily the original intent of the parties." Rather, the court stated, the determination should be made annually based on all facts and circumstances, as opposed to an initial characterization on the issuer's tax return.

- After establishing that IRS Section 385(c) did not apply, the court analyzed the transactions under Hardman v. United States, 827 F.2d 1409 (9th Cir. 1987) and other cases listing debt-equity factors to determine whether the transfers from Crown could be considered constructive distributions to Mr. Fry, followed by capital contributions to CR Maintenance.

Example

- Of the 11 Hardman factors, the court found four neutral and only one favoring classification of the transactions as debt, specifically that the parties originally intended for the transfers to create indebtedness.

- The court found six of the 11 Hardman factors favored the creations of an equity interest, particularly that:

Example

– Repayment depended on CR Maintenance's future success
– Crown never obtained a security interest
– Crown's right to repayment was subordinate to any other creditors
– The interests of the two businesses were significantly intertwined
– Interest payments were not expected
– CR Maintenance could not obtain loans from outside lenders

Example

- The court also found that the transfers satisfied both prongs of the constructive dividend test under Ninth Circuit case law1 because the expenditure did not give rise to a deduction on behalf of Crown and, more critically, resulted in an economic benefit for Mr. Fry. According to the opinion, there was no discernable business reason for Crown to make the transfers and payments at issue and no true expectation of timely repayment or interest other than for Mr. Fry's benefit in keeping CR Maintenance afloat. The court also held that the duty of consistency and the doctrine of election did not prevent the Frys from treating the payments as equity. Regarding the former, the IRS was unable to prove that it would be harmed by the change. Regarding the latter, the court did not view the debt-equity determination as a free choice or an election, but rather a determination based on the various factors that indicate the true economic substance of a transaction.

Example

- As the court noted, only one court has ever cited IRC Section 385(c) and only in passing. In contrast, the IRS has issued several forms of informal advice on the provision, some of which consider tax return treatment relevant to the characterization for IRC Section 385(c) purposes in the absence of a legal instrument (See FSA 200004011). Thus, the court's determination that there was no "characterization" for purposes of IRC Section 385(c) in the instant case because there was no legal issuance of an instrument is noteworthy.

- The court gave little weight to the parties' original intent for purposes of characterizing the interest and suggested performing the debt-equity test annually based on all facts and circumstances. The court's comment suggests an instrument's characterization may transform from debt to equity or vice versa depending on the facts and circumstances, which should be evaluated annually.

VII. Reasonable Compensation

A. Rule

- 1. Fact Sheet 2008-25, August 2008 lists these factors that courts have considered in determining reasonable compensation.
  – Training and experience;
  – Duties and responsibilities;
  – Time and effort devoted to the business;
  – Dividend history;
  – Payments to non-shareholder employees;
  – Timing and manner of paying bonuses to key people;
  – What comparable businesses pay for similar services;
  – Compensation agreements; and
  – Use of a formula to determine compensation.

- 2. The 5th Circuit continues to use these factors in assessing cases.

VIII. Accumulated Adjustments Account

A. General

- 1. The AAA account is the cumulative total of ordinary income (loss) and separately stated items accumulated for the S period. It excludes tax-exempt income and expenses.
- 2. The AAA starts at zero on the first day the S election is effective in tax years after 1982.
- 3. The AAA account is adjusted annually in a similar manner to the shareholder's stock basis.
- 4. The income, loss, and deductions for the S corporation, whether separately stated or nonseparately stated, will correspondingly increase or decrease the AAA account. Distributions from AAA will reduce the AAA. The formula is shown below:

A. General

- FORMULA
- AAA   Balance at the beginning of the tax year
- Plus: Ordinary Income
  – Separately stated income and gains (exclude tax-exempt income)
- Less: Ordinary Loss
  – Separately stated loss and deductions (exclude tax-exempt expenses)
  – Expenses not deductible in determining ordinary income (loss) and not Charged to the capital account
  – Distributions from AAA
- AAA Balance at the end of the tax year

A. General

- 4. In many cases, the adjustments to AAA will parallel the adjustments to the shareholder's stock basis. However, exceptions exist. The primary differences are:

- a. The shareholder's initial stock purchase is not included in AAA, whereas the purchase is included in stock basis;

- b. Shareholder contributions of capital to the corporation are included in stock basis, but are not included in AAA;

A. General

- c. The stock basis is increased by tax exempt income and reduced by related expenses, but AAA is not increased by tax exempt income, or reduced by related expenses (See Section 1368(e)(1)); and
- d. When an S corporation pays federal income taxes arising from a C corporation year, the shareholder's stock basis is reduced, but the AAA account is not reduced (See Section 1368(e)(1)).

B. Regulations on Eligible Terminated S Corporation – TD 9914

- 1. The IRS issued final regulations under Sections 481(d) and 1371(f) regarding the treatment of “eligible terminated S corporations” (ETSCs). The regulations provide guidance on the definition of an ETSC and rules relating to distributions of money by such a corporation after its post-termination transition period. They also amend the regulations under Sec. 1371(f) to extend the treatment of distributions of money during the post-termination transition period (PTTP) to all shareholders of the corporation and clarify the allocation of current earnings and profits to distributions of money and other property.

- 2. To make it easier for S corporations to revoke their S elections, Congress, as part of Tax Cuts and Jobs Act (TCJA)enacted Section 481(d)(1), which permits a corporation that qualifies as an ETSC to take into account any Section 481 adjustments that are attributable to the revocation of an S election over the inclusion period which is six-tax-year period beginning with the year of change to an S corporation.

B. Regulations on Eligible Terminated S Corporation – TD 9914

- 3. An ETSC is a C corporation meeting the following three requirements:
  - The corporation was an S corporation on Dec. 21, 2017;
  - The S corporation revoked its Sec. 1362(a) election to be an S corporation during the two-year period beginning on Dec. 22, 2017 (revocation requirement); and
  - The owners of the stock of the corporation, determined on the date the corporation made a revocation of its S election, are the same owners (and own identical proportions of the corporation's stock) as on Dec. 22, 2017 (shareholder identity requirement).

B. Regulations on Eligible Terminated S Corporation – TD 9914

- 4. The TCJA added Section 1371(f), which extends the period during which an ETSC's shareholders can benefit from the AAA generated during the corporation's former status as an S corporation (ETSC period) by providing that, in the case of distributions of money following the PTTP:
  - The distributing ETSC's AAA is allocated to a distribution of money to which Sec. 301 would otherwise apply (qualified distribution), and
  - The qualified distribution is chargeable to AE&P in the same ratio as the amount of the AAA bears to the amount of the AE&P.

- 5. The final regulations provide that, solely for revocations with retroactive effective dates, a revocation may be treated as having been made on the effective date of that revocation.

B. Regulations on Eligible Terminated S Corporation – TD 9914

- f. Hence. a corporation may test compliance with the revocation requirement and the shareholder identity requirement on either the date the revocation was made or, in the case of a revocation with a retroactive effective date, the date the revocation was effective. This change clarifies who the shareholders are on the revocation date.

- 6 In addition, the final regulation clarified that Section 7503 applies to the requirement to make the revocation within two years. If the last day prescribed for making a revocation occurs on a Saturday, Sunday, or a legal holiday, Sec. 7503 applies in determining whether the revocation was made within the two-year period.

B. Regulations on Eligible Terminated S Corporation – TD 9914

- 7. The regulations are effective when they are published in the Federal Register and apply to tax years beginning after that date .A corporation may choose to apply the rules in their entirety to tax years beginning on or before the date they are published, but all the shareholders of the corporation must report consistently and the corporation must continue to apply the rules in their entirety for the corporation's subsequent tax years.

IX. S Corporations and Cash Method of Accounting

A. General Rule

- 1. Generally, S corporations may use the cash method of accounting, regardless of gross receipts. Section 448, however, denies the use of the cash method for any S corporation determined to be a tax shelter.

B. New Regulations Provide Relief From Classification As Syndicate – TD 9942 & 9943

- 1. The Treasury finalized regulations that could allow some 2021 calendar-year partnerships and S corporations to retain the cash method that might otherwise lose it. The regulations have effective dates for years beginning after January 5, 2021, but allow the provisions to be applied to earlier years.

- 2. The regulations allow taxpayers to avoid is referred to as the syndicate rule. This rule requires any partnership or S corporation that allocates more than 35% of losses in a year to limited partners or limited entrepreneurs to change from the cash method. Limited entrepreneurs are those owners not active in management. This category includes owners of voting stock and even members of the board of directors.

- 3. An entity classified as a syndicate loses more than just the ability to use the cash method.

B. New Regulations Provide Relief From Classification As Syndicate – TD 9942 & 9943

- 4. Classification as a syndicate also limits the ability of the entity to use the small business exception for several other Code provisions including the Sec. 163(j)(3) business interest deduction, the Sec. 460(e)(1)(B) percentage-of-completion method for construction contracts, the Sec. 263A(i) UNICAP exception, and the Sec. 471(b) inventory rules exception.

- 5. Under the finalized regulations, if an S corporation would be classified as a syndicate using its current year's allocations, it can elect to use the prior year. (See Regs. Sec. 1.448-2(b)(2)(iii)(B)).

- 6. This election is irrevocable but applies only to the year for which the corporation elects.

- 7.An entity-level profit in the prior year will also allow an election to be made to continue using the cash method.

Example

- Assume a partnership or S corporation using the cash method is profitable in 2020. In 2021, the entity has a loss, and more than 35% of that loss will be allocable to limited partners or limited entrepreneurs. The entity would, under the rules in place prior to this change, be required to change from the cash method for 2021. Under the new rule, the entity can elect to use the 2020 allocations instead of the 2021 allocations. Syndicate status is avoided for 2021, and the cash method can continue to be used.

B. New Regulations Provide Relief From Classification As Syndicate – TD 9942 & 9943

- 8. The S corporation must make the election on a timely filed return (including extensions) and must state the authority under which it is being made, Regs. Sec. 1.448-2(b)(2)(iii)(B). The election is irrevocable.

- 9. The regulation restates, without change, the method for determining if a loss exists. The regulation initially provides the same language as the prior regulation:

- The losses of a partnership, entity, or enterprise (entities) means the excess of the deductions allowable to the entities over the amount of income recognized by such entities under the entities' method of accounting used for Federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or assets described in Sec. 1221(a)(2) are not taken into account.

B. New Regulations Provide Relief From Classification As Syndicate – TD 9942 & 9943

- 10. The newly finalized regulations add a new provision: the computation is to be done without regard to the interest expense limitations of Sec. 163(j).

- 11. This election gives tax advisers planning opportunities. For this purpose, profits, no matter how small, are always good, and losses, no matter how small, are bad if more than 35% would go to limited partners or owners not active in management. To the degree one can legitimately time income recognition or expense deductions to result in an entity showing a profit, the cash method, and other methods mentioned, are protected both for the current year and the following year.

SECTION XV:

PARTNERSHIP AND LLC ISSUES

I. Form 1065 Updates

A. IR 2023 – 162. IRS Issues FAQ for Passthrough Entities to Report Negative Amounts electronically to IRS on Part II of Schedules K – 2 and K – 3

- 1. A pass-through entity receives information that certain gross income amounts to be reported on Schedules K – 2 and K – 3 are negative. The current schema for electronic filing of the Schedules K – 2 and K – 3 do not permit negative values for certain line items in Part II, Section 1 of the schedules. Since the schema does not allow for the negative amounts to be reported electronically, the taxpayer should enter zero on the line items in Schedules K – 2 and K – 3, Part II, section 1 and then attach a General Dependency (XML) schema to Schedule K – 2 identify the line items and the negative values for which the pass-through entity reported zero. Also, the pass-through entity should attach a list of the impacted line items and the negative numbers.

B. IRS Releases Information on MeF Error Message, Form 1065 Changes

- 1. The IRS released two new answers to frequently asked questions (FAQs) on e-filing Form 1065. These FAQs address an e-file error message and how to identify a foreign partner now that the designation "FOREIGNUS" has been removed as an option.

- 2. The first FAQ addresses how to correct an error message a filer received when using code ZZ on line 20 of Schedule K-1.

- a. According to the answer there was a programming error impacting 2023 Form 1065 e-filers that blocks e-filed partnership returns from using code ZZ. The IRS recommends that e-filers get an extension to file their 2023 Form 1065 returns and defer trying to e-file those returns until June 16, 2024, when the IRS estimates that the code ZZ problem will be fixed.

B. IRS Releases Information on MeF Error Message, Form 1065 Changes

- 3. The second FAQ addresses partnerships e-filing Form 1065 that use Part II, Item E, on Schedule K-1 and Item C, on Schedule K-3.

- a. According to the IRS' answer, a partnership must enter a partner's SSN or Taxpayer Identification Number (TIN) on Schedule K-1, Part II, Item E. In past years, when a foreign partner didn't have an SSN or a TIN, many partnerships entered "FOREIGNUS" instead. However, for partnerships that e-file, the "FOREIGNUS" designation has been removed.

B. IRS Releases Information on MeF Error Message, Form 1065 Changes

- 4. The IRS wants e-filing partnerships to enter 000-00-0000 in Item E if the partner is an individual or 00-0000000 if the partner is an entity. Partnerships should use this procedure only for foreign partners who are not required to obtain an SSN or TIN.

- 5. This same procedure should be used to complete Item C on Schedule K-3.

- 6. The IRS notes that this "change in e-file policy at the IRS should not be interpreted by partners, partnerships, and their tax preparers as a policy that partners who were not previously required to obtain an SSN or TIN are now required to do so."

C. Form 1065 – X

- a. For tax years beginning on or after January 1, 2023, the practitioner should use the August 2 023 revision of Form 1065 – X.
- b. Under the 2023 revision, Part 1, Section 2 – BBA AAR. Item C 2 has been added to indicate when adjustments do not result in the imputed underpayment. Likewise, Part II, Line 13 is changed from Contributions to Cash Contributions and Line 13 B is added for Non-cash contributions.
- c. Remember, partnerships under the BBA must file an Administrative Adjustment Request (AAR) instead of an amended return.

II. Receipt of Partnership Interest – Section 721 (a)

A. General Rules

- 1. Section 721 (a) provides that the receipt of a partnership interest in exchange for property is generally nontaxable. However, where a person receives a partnership interest in exchange for a contribution of services, nonrecognition is not always guaranteed.

- 2. Under Regulation 1.721 – 1 (b) (1), the receipt of a partnership capital interest in exchange for services is taxable to the service provider. The IRS issued Rev. Proc. 93 – 27 providing guidance on the treatment of the receipt of a profit interest for services provided to or for the benefit of the partnership. The Revenue Procedure also stated the receipt of capital interest for services is treated as compensation. The regulation does say that there can be exceptions to the nonrecognition of a profit interest so received.

Example

- ES NPA Holdings, LLC v. Comm., TC Memo 2023 – 53. A corporation contributed substantially all of its business assets to LLC 1 in exchange for all three classes of units in LLC 1 (A, B, and C). The corporation then contributed all three classes of units in LLC 1 to LLC 2 as a capital contribution. The next day, a third LLC purchased all of LLC 1's Class A units from LLC 2, and ES NPA acquired all of LLC 2's Class C units in exchange for payment to the corporation of $100,000 and services provided or to be provided. ES NPA's acquisition of the Class C units in LLC 2 reflected an indirect interest in the Class C units of LLC 1. After all of the transactions, the records showed that the LLC 1 Class A units held by the third LLC had a capital contribution of $20,985,509; the LLC 1 Class B units held by LLC 2 had a capital contribution of $8,993,790; and the LLC 1 Class C units held by LLC 2 had a capital contribution of zero.

Example

- ES NPA did not report any gain on the receipt of the LLC units in this transaction because it contended that its interest in LLC 2 was a profits interest, the receipt of which was not taxable under Rev. Proc. 93-27. On audit, the IRS determined that ES NPA had income on the receipt of the interest in LLC 2. The IRS argued that the revenue procedure did not apply in this situation because ES NPA received a taxable capital interest in LLC 2. The Tax Court disagreed and found that the receipt of LLC 1 units via an interest in LLC 2 qualified as a profits interest under Rev. Proc. 93-27; thus, ES NPA did not have any gain on the transaction. The court stated that it did not matter that the units were held indirectly.

B. Substantial Economic Effect

- 1. Under the Partnership Tax Provisions, taxpayers are entitled to structure their business transactions in a manner that produces the least amount of tax. However the transactions must meet the definition of substantial economic effect. For this to occur there must be a reasonable possibility of profit and independent business purpose beyond reducing taxes.

- 2 Section 704 (d) allows a taxpayer to deduct losses from a partnership interest if the taxpayer has basis in the interest. Any losses in excess of basis are disallowed and carried forward until the partner’s basis is restored.

Examples

- GSS Holdings in 02021 – 2353 (Fed Cir. 9.21.23), the vacating and remanding 154 Fed Cl 481. The taxpayer entered into a set of various transactions resulting in a partnership loss allocated to the taxpayer. The Service determined the transaction should be treated as a single transaction under the step transaction doctrine and disallowed the loss under Section 707 (b) (1) as a loss from the sale of property between the partnership and a person owning more than 50% of the capital interest in the partnership. On appeal, the taxpayer argued that the lower court made two errors. First, the court applied a hybrid legal standard that conflated the step transaction doctrine and economic substance doctrine.

Examples

- Second, the court violated the principles of party presentation. Specifically, the taxpayer argued that in analyzing the step transaction doctrine the court used the economic substance doctrine rule by looking only at the steps that created the tax benefit. The Federal Circuit Ct. agreed with the taxpayer and vacated the lower court's decision remanding it back stating to the lower court to make a determination using the correct legal standard.. Specifically the court is required to examine whether the transaction were component parts of a single transaction intended from the get go be taken for purposes of reaching the tax result.

Examples

- Kamal v. Comm., TC Memo 2023 – 80. The Service disallowed a married couple's partnership loss deduction for the lack the substantiation. Oral testimony was not enough to overcome the lack of substantiation. The taxpayers offer no evidence showing a connection between the taxpayers and the business as such the deductions were disallowed.

- Simpson v. Comm., TC Memo 2023 – 4. The taxpayers owned an S corporation that was a member in an unsuccessful rental LLC, they deducted the entire loss that was allocated to the S corporation. The IRS allowed only a portion of the loss because the taxpayers could not provide documentation to substantiate their basis in the LLC interest. The taxpayers argued that they had made additional capital contributions to the LLC on behalf of the S corporation and that other members had agreed to gift portions of their interests in the LLC to the S corporation. However, that assertion was not supported by the evidence in the case, the Tax Court held. The court agreed with the IRS and determined that the taxpayers were not allowed to deduct the entire loss.

Examples

- Dunn v. Comm., TC Memo 2022 – 112. The taxpayers owned a real estate rental and investment management partnership that allocated them losses that they deducted on their joint personal tax return. On audit, the IRS disallowed the losses because the taxpayers did not have basis in the partnership interest. The Tax Court agreed because the taxpayers were not able to show that they had sufficient basis in their partnership interest to deduct their pro rata shares of the partnership’s losses. They also failed to show that any amounts in respect of their rental real estate activities were at risk under Sec. 465.

Examples

- The taxpayers also tried to argue that they should be allowed to deduct the losses as real estate professionals under Sec. 469(c)(7). Again, the court rejected their argument because the taxpayers did not provide any evidence to show that they qualified as real estate professionals. The court noted that the taxpayers failed to show that half of their time was spent performing services in real property trades or businesses or that either of them met the 750-hour test. Although the taxpayers provided time logs of hours they spent on real estate activities, those records provided only “vague and misleading estimates,” the court held.

III. Sale of Partnership Interest

A. Section 741

- 1. Section 741 provide that in the case of a sale or exchange of a partnership interest, gain or loss shall be recognized to the transferor partner.
- 2. The gain or loss shall be considered a gain or loss from the sale or exchange of a capital asset except as otherwise provided under Section 751 which relates to unrealized receivables and inventory items.
- 3. Section 1221 (a) provides that the term capital asset means property held by the taxpayer whether or not connected with a trade or business but does not include stock in trade of the taxpayer or other property of the kind that would be included in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business.

Example

- **Rawat v. Comm., TC Memo 2023 – 14**. The taxpayer, a nonresident alien, as a partner in a U.S. partnership. In 2008 (i.e., before the 2017 effective date of Section 864(c)(8)), the taxpayer sold her interest in the partnership. Part of the sale was attributable to inventory items for purposes of Section 751(a)(2). This part of the gain should be treated as ordinary income, the IRS asserted in a notice of computational adjustment. However, the taxpayer had treated the entire gain on the sale as a capital gain under Section 741. She argued that the gain would be treated as income from the sale of a single asset (the partnership interest) that was personal property under the general rule of Section 865(a)(2) and was therefore non–U.S.-source income. The IRS determined that Section 751(a)(2) governs the gain attributable to inventory items and provides an exception from the general rule of Section 741.

Example

- The portion of the gain would be ordinary income, the IRS argued. The Service argued, for purposes of the sourcing rules, “income derived from the sale of inventory property” falls under the exception in Section 865(b) from the general rule of 8 Section 65(a)(2) and therefore in this case was U.S.-source income. The Tax Court agreed with the IRS, finding the taxpayer’s theory that the proceeds were treated as gain from the sale of a single capital asset that would be income sourced outside the U.S. failed because Section 741’s general rule for analyzing the sale of a partnership interest as a singular capital asset rather than evaluating the gain on an asset-by-asset basis is superseded by Section 751(a)(2)’s specific provision treating the portion attributable to inventory items as from property other than a capital asset.

IV. Foreign Partnerships

A. Reporting Requirements

- 1. A U.S. person that owns an interest in a foreign partnership may be required to complete and file a Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, to report the activities of the foreign partnership.
- 2. Certain foreign partnerships may be required to file a Form 1065, U.S. Return of Partnership Income, and provide their partners Form 1065, Schedule K-1, Partner's Share of Income, Deductions, Credits, etc. (See Section 6038 and 6031).
- 3. A foreign partnership may be required to file either or both forms.

A. Reporting Requirements

- 4. Form 8865 is used by U.S. persons to report the following:
  - Certain information regarding Controlled Foreign Partnerships – Section 6038,
  - Transfers to Foreign Partnerships – Section 6038 B
  - Acquisitions, dispositions and Changes in foreign partnership interests – 6046 A

- 5. Those US persons required to file the form generally fall within one of four categories:

A. Reporting Requirements

- Category 1: A U.S. person who controlled the foreign partnership at any time during the partnership's tax year. Control of a partnership is ownership of more than a 50% interest in the partnership. A Category 1 filer also includes a U.S. transferor who must report certain information for a Sec. 721(c) partnership for the tax year of contribution and subsequent years, pursuant to Regs. Sec. 1.721(c)-6.

- Category 2: A U.S. person who at any time during the tax year of the foreign partnership owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons each owning at least a 10% interest. However, if the foreign partnership had a Category 1 filer at any time during that tax year, no person will be considered a Category 2 filer.

A. Reporting Requirements

- Category 3: A U.S. person who contributed property during that person's tax year to a foreign partnership in exchange for an interest in the partnership, if that person either: (1) owned directly or indirectly at least a 10% interest in the foreign partnership immediately after the contribution, or (2) contributed property with an aggregate value exceeding $100,000 during the 12-month period ending on the date of transfer.

- Category 4: A U.S. person that had a Sec. 6046A reportable event during that person's tax year. There are three categories of reportable events under Sec. 6046A: acquisitions, dispositions, and changes in proportional interests.

A. Reporting Requirements

- 6. If the US taxpayer does not have to file income tax return the form is still to be filed separately.
- 7. If a U.S. person qualifies under more than one category for a particular foreign partnership, they must submit all the items required for each category they qualify for.

B. Foreign Partnership Filing Form 1065

- 1. A foreign partnership is required to file Form 1065 (and report all its foreign and U.S. partnership items) if it has either of the following:
  - Gross income derived from sources within the United States, or
  - Gross income that is effectively connected with the conduct of a trade or business within the United States (See Section 6031(e)(2)).

- 2. Foreign partners are subject to U.S. tax on their share of U.S.-source income and effectively connected income (ECI) and the requirement for a foreign partnership to file Form 1065 assists with administering the U.S. nonresident taxing regimes.

B. Foreign Partnership Filing Form 1065

- 3. If the taxpayers engagement trade or business in the United States, the general rule is that all income is effectively connected income. (See Section 864 (c) (3) likewise, income that would be US source investment income is also effectively connected income if it is derived from assets used in the conduct of US trade or business or if the activities the trade or business are material fact or in the realization of income.

- 4. Income from foreign sources is not treated as effectively connected income and therefore is not taxable in the United States. (See Section 864 (c) (4))

C. Reporting Exceptions

- 1. Even if a foreign partnership has U.S.-source income, it is not required to file Form 1065 if it qualifies for one of two exceptions. First, foreign partnerships with U.S. partners are not required to file Form 1065 if all the following provisions are met:
  - The partnership had no ECI during its tax year;
  - The partnership had U.S.-source income of $20,000 or less during its tax year;
  - Less than 1% of any partnership item of income, gain, loss, deduction, or credit was allocable in the aggregate to direct U.S. partners at any time during its tax year; and
  - The partnership is not a withholding foreign partnership (as defined in Regs. Sec. 1.1441-5(c)(2)(i)) (Regs. Sec. 1.6031(a)-1(b) and Form 1065 instructions).

C. Reporting Exceptions

- 2. Foreign partnerships with no U.S. partners and no ECI are not required to file Form 1065 if all the following provisions are met:
  - The partnership had no ECI during its tax year;
  - The partnership had no U.S. partners at any time during its tax year;
  - The partnership is not a withholding foreign partnership as defined in Regs. Sec. 1.1441-5(c)(2)(i);
  - All required Forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, were filed by the partnership or another withholding agent as required by Regs. Secs. 1.1461- 1(b) and (c); and
  - The tax liability of each partner for amounts reportable under Regs. Secs. 1.1461-1(b) and (c) has been fully satisfied by the withholding of tax at the source (Regs. Sec. 1.6031(a)-1(b)(3)).

D. Withholding Requirements

- 1. In 2020 IRS issued final regulations relating to withholding on a transfer of an interest in a PTP under Section 1446 (f).

- 2. Under 1446 (f), brokers that effect a transfer of a PTP interest on behalf of the transferor to withhold on the payment made to the transferor. The broker is not required to withhold or may withhold at a reduced rate if they can rely on either a certification from the transferor that claims an exception or reduction to the withholding or a representation made by the PTP on a qualified notice indicating that the exception under Regulation 1.1446 (f) – 4 (b) (3) (ii). The latter is a 10% exception.

- 3. A broker is also not required to withhold when it makes the payment of an amount realized to a qualified intermediary, or a U.S. branch treated as a U.S. person, that assumes primary withholding responsibility under Section 1446(f)(1).

E. Notice 2023 – 8

- 1. This notice provides additional guidance for brokers to comply with the provisions of the final regulations under Sec. 1446(f). According to the notice, Treasury and the IRS intend to issue proposed regulations that would amend the final regulations to implement this additional guidance.

- 2. The proposed regulations would apply to a transfer or distributions made on or after January 1, 2023.

- 3. The notice provides additional guidance for brokers to comply with the provisions of the final regulations. The IRS intends to issue proposed regulations regarding implementation of the notice.

E. Notice 2023 – 8

- 4. Specifically, the IRS and treasury have concluded that burden is on brokers to determine whether a foreign entity that trades on a foreign market is a PTP for U.S. tax purposes would likely be disproportionate to the amount of gain subject to Section 864(c)(8) on transfers of interests in such entities. They intend to issue proposed regulations that would amend the final regulations to provide withholding relief to brokers on the sale of an interest in an entity that is organized outside the United States and that trades solely on a foreign established securities market or foreign secondary market (foreign-traded entity).

E. Notice 2023 – 8

- 4. This proposed amendment would allow a broker that effects a sale of an interest in a foreign-traded entity to presume that the entity is not a PTP for U.S. tax purposes unless the broker has actual knowledge otherwise. However, because it would be inappropriate to allow a broker that knows that a foreign-traded entity is a PTP for U.S. tax purposes to presume that the PTP does not have effectively connected income, Treasury and the IRS do not intend to include such a presumption in the proposed regulations.

E. Notice 2023 – 8

- 5. Under the 2020 final regulations, a broker may rely on a certification from a transferor that claims an exception or reduction to withholding. However, a broker generally may not rely on a certification if it is received earlier than 30 days before a transfer or at any time after a transfer. Taxpayers and other stakeholders have requested an allowance for brokers to rely on late certifications that claim an exception or reduction to withholding on the transfer of a PTP interest.

- 6. According to the notice, Treasury and the IRS have determined that it is appropriate to allow brokers to rely on late certifications for purposes of withholding under Sec. 1446(f) in order to reduce over withholding and claims for refund and to better coordinate with the documentation rules under Sections 1441 and 1471.

F. Foreign Issues -Form 8832: Entity Classification Election

- 1. Foreign entities formed as LLCs that want to be taxed as a partnership in the United States must make an election on Form 8832.
- b. Without this election, this type of entity defaults to a corporation.
- 2. The Service does allow a late election not exceeding 120 days after the ruling to file the election.(See 202113004, 202130010, 202136001, and 202138005)

V. Extent of Recognition of Gain or Loss on Distribution – Section 731

A. General Rule

- 1. Section 731 (a) (1) states that gain shall not be recognized to a partner except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

- 2. Section 705 (a) is the basic provision to determine adjusted basis in a partnership. Adjusted basis is as follows:

- Contributions – cash or property
- +Increases to partner's share of liabilities
- + Allocable share of taxable income
- +Allocable share of tax exempt income
- -Allocable share of tax losses
- - Distributions – cash or property
- -Decrease to partner's share of partnership liabilities
- -Nondeductible expenses

A. General Rule

- 3. With respect to distributions of property, section 732 states that a partner’s basis were generally be equal to the partnership’s basis in the property distributed. As to liquidating distributions, the partner’s basis in the property will generally be equal to the basis of their partnership interest.

A. General Rule

- Examples
- Jim is a partner in a limited partnership with the adjusted basis of $10,000. He received a cash distribution of $8,000. Under Section 731 no gain is recognized as the distribution does not exceed his basis. However, his basis would be reduced by the $8,000

- Now Jim has a basis in a limited partnership of $10,000. He receives a cash distribution of $8000 and a distribution of property with a fair market value of $3000. The partner's basis in the property would be $2000 under Section 732. It is the lesser of the partnership's adjusted basis in the property or the partners adjusted basis in their partnership interest. The adjusted basis in their partnership interest would be zero.

- 4. An increase in a partner's share of partnership liabilities is considered a contribution of money by the partner. Likewise, a decrease in a partner share of liabilities is considered a distribution of money to the partner (economic benefit)

B. Guaranteed Payments

- 1. Payments received by a partner from a partnership that are determined without regard to the income of the partnership are classified as guaranteed payments under Section 707(c) and are taxable as ordinary income.

- 2. Payments received by a partner that are determined with regard to partnership income and/or are in the nature of current or liquidating distributions may be taxable as capital gain to the extent that they exceed a partner's basis in the partnership. (See Section 731(a))

- 3. Payments made to a partner for services that are determined without regard to partnership income may be deductible by the partnership as ordinary and necessary business expenses. Such payments may also be subject to self-employment tax or Social Security as the case may be.

Example

- Abel is a partner in the ABC partnership he is entitled to a fixed annual payment of $10,000 for services regardless of the income generated by the partnership. His distributive share is 10%. After deducting the guaranteed payment the partnership has $50,000 of ordinary income. Abel must include $15,000 as ordinary income for the taxable year consisting of the $10,000 guaranteed payment and $5000 that is his allocable distributable share.

C. Section 704 Distributions

- 1. If a partner contributed property to a partnership in a tax-free event and subsequently received a property distribution from the partnership income recognition could be triggered. Specifically under Section 704 (c) if property is distributed by the partnership (other than to the contributing partner) within seven years of being contributed, the contributing partner will recognize gain or loss equal to the amount of gain or loss the contributing partner would be allocated had the partnership sold the property at its fair market value on the date of the distribution.

- 2. The amount allocable to the contributed partner is an amount equal to the properties remaining built-in gain or loss.

- 3. Under this specific section the contributing partner as opposed to the receiving partner has the income recognition.

C. Section 704 Distributions

- Example

- John acquires an interest in ABC partnership in 2020 by contributing Blackacre, non-depreciable, to the partnership. Blackacre has a fair market value of $10,000 and adjusted basis of $4000. In 2024, the partnership distributes Blackacre to Chuck in liquidation of his interest in the partnership. John will recognize the built-in gain of $6000 because the property was distributed out to another partner in the seven year timeframe.

C. Section 704 Distributions

- 4. It should be noted that under Section 704 (c) (2) there is an different rule for distributions of a like kind property. If property is distributed to a partner other than the contributing partner and like kind property is distributed to the contributing partner the amount of the gain or loss that the contributing partner would have to recognize is reduced by the amount of the built-in gain or loss in the distributed like kind property.

D. Section 737 – Recognition of Precontribution Gain in Distributions to Contributing Partners

- 1. Section 737 addresses scenarios where a partner that previously contributed property to a partnership receives a distribution of property other than money.

- 2. Section 737 requires the partner to recognize gain equal to the lesser of:
  - The excess distribution. The excess distribution is the amount by which the fair market value of the distributed property, other than money, exceeds the distributee partner's adjusted tax basis in the partner's partnership interest. The partner's adjusted basis is reduced, but not below zero, for distributions of money received in the distribution; or
  - The partner's net precontribution gain. The net precontribution gain is the same amount of gain that a partner would recognize under Section 704 if all property held by the partnership immediately before the distribution that was contributed to the partnership by the distributee partner within 7 years of the distribution was distributed to another partner.

D. Section 737 – Recognition of Precontribution Gain in Distributions to Contributing Partners

- Example

- John acquires an interest in ABC partnership in 2020 by contributing Blackacre, non-depreciable, to the partnership. Blackacre has a fair market value of $10,000 and adjusted basis of $4000. Jane contributes Greenacre, also nondepreciable, with a fair market value and adjusted basis of $30,000. In 2024, the partnership distributes Greenacre to John in liquidation of his interest. At the time of the distribution, Green Acres fair market value still $30,000 and John's adjusted basis in the partnership is $20,000. John will be required to recognize gain of $6000. This consists of his pre-contribution gain since it is less than the excess distribution amount of $10,000 ($30,000 $-20,000).

E. Disguised Sale Distributions

- 1. Regulation Section 1.707 – 3 states that a transfer of property by a partner to a partnership in one or more transfers of money or other consideration by the partnership to that partner will be treated as a sale of property if the transfer of money or other consideration would not have been made but for the transfer of the property.

- 2. Likewise Regulation Section 1.707 – 6 states that a transfer of property by a partnership to a partner in one or more transfers of money or other consideration by that partner to the partnership will be deemed a sale.

E. Disguised Sale Distributions

- 3. This is a fact and circumstance test with the following factors examined to determine if the transaction was in fact a disguised sale:
  - The timing and amount of the subsequent transfer are determinable with reasonable certainty;
  - The transferor has a legally enforceable right to the subsequent transfer;
  - The right to receive the transfer of money or other consideration is secured; and
  - The transfer of money or other consideration is disproportionately large in relation to the partner's continuing interest in partnership profits.

E. Disguised Sale Distributions

- 4. Transfers of property that occur within two years of a transfer money are presumed to be a sale unless facts and circumstance establish the transfer did not constitute a sale. Transfer subject to this presumption require disclosure if the transfer is not treated as a sale. The following are presumed to not be a sale of property unless facts and circumstance demonstrate otherwise:
  - Transfers occurring more than two years apart;
  - Reasonable guaranteed payments;
  - Reasonable preferred returns;
  - Distributions of operating cash flow; and
  - Reimbursements of preformation expenditures. (See Regulations Section 1.707 – 4)

F. Distribution of Hot Assets

- 1. Under Section 751 (b) distributions of unrealized receivables or substantially appreciating property are treated in part a sale or exchange of property between the partnership and the distributee partner and or not distributions subject to Section 731 and 736. Translation, such distributions are ordinary income in nature to the distributee partner.

Example

- ABC partnership is equally owned by Moe, Larry and Curly each have an adjusted basis in their partnership interest of $100. The partnership's balance sheet has cash of $300, accounts receivable of $300 with zero tax basis and no liabilities. Curly receives a cash distribution of $200 in liquidation of his interest in the partnership. He has a gain of $100 that would normally be a capital gain. However the gain will be recharacterized as ordinary income to the extent of his interest in the accounts receivables decreases. The entire hundred dollar gain would be ordinary income since his interest in the receivables was reduced by one third (one third of $300) the outcome replicates what would have happened if the partnership had collected the receivable recognized income and allocated the hundred dollars to each partner in that case Curly's basis would increase from to $100 to $200 and no gain would've been recognized since the cash distribution equal is adjusted basis. If the partnership can distribute $200 of accounts receivable to currently in liquidation of his interest the partnership not currently would have recognized gain and would have been allocated to the other two partners.

VI. Basis Issues

A. General

- 1. Generally, losses from a partnership or LLC are deductible to the extent of the partners basis in the partnership.

- 2. One of the primary advantages that partnerships possess over S Corporations is that the partnership debt is included in the partner's basis computation as a general rule. This has an effect on the deductibility of losses and the potential determination of gain on subsequent distributions. The general rule is that the debts of the partnership or LLC are nonrecourse in nature.

- 3. Reg. Sec. 1.465 – 6(d) provides that guarantees by partners do not increase their at risk basis until the guarantee is paid by the partner. Obviously, when a partnership or a partner personally guarantees a partnership debt, that is recourse debt in nature. When the partner does not guarantee the debt of the partnership is nonrecourse in nature. Likewise, the general partner or managing member bearing the economic risk of loss in a partnership or LLC is considered to have recourse debt. The partnership as a general rule treats partnership debt as nonrecourse unless it is specifically guaranteed by the partner or member as the case may be.

B. Inside Basis

- 1.This represents the partnerships basis in the partnership assets.
- 2.A Partnership will take carryover basis in property contributed to the partnership equal to the contributing partners adjusted basis at the time the contribution is made.
- 3. Inside basis is the aggregate or total adjusted basis of all property contributed by all partners are all members to the partnership.

C. Outside Basis

- 1. Outside Basis represents the individual partner or member's adjusted basis in their partnership or LLC interest. Basically, a partners or members outside basis is there a separate tax capital account.

- 2. The partner' s separate tax capital account reflects adjusted basis of property plus the partner's share of the partnership or LLC debt.

- 3. Outside basis is initially determined by including the amount of the adjusted basis in the property contributed plus any cash contributed by a partner or member.

- 4. If there are liabilities, outside basis would include the partner or member share of all liabilities assumed.

- 5. In each year after the initial contribution, the outside basis increased or decreased by the partnership or LLC operations and operating activity.

C. Outside Basis

- 6.Outside basis is what is used to determine any loss limitations as well as determining taxability of partners are LLCs distributions and computed the gain or loss on distribution in the event and interest is sold or terminated.

- 7. Obviously, outside basis is an annual determination and is generally reflected on the K – 1 of each partner or member.

- 8. There is a relationship between inside and outside basis as they both reflect the adjusted basis of assets vs fair market value. However, outside basis deals with each individual partner or member’s interest in the partnership or LLC assets they contributed whereas inside basis deals with all partners or members interest in the partnership or all assets aggregated together.

C. Outside Basis

- 9. The sum of the partnership or LLC inside basis in all of the partnership or LLC assets should equal the aggregate or total of all individual partners are members outside basis at formation.

- 10. There are situations after formation where inside basis and outside basis do not equal each other. The situations can include the purchase of a partnership or LLC interest at fair market value, property distributed where the outside basis does not equal the partnership basis in the property or death of a partner or member causing basis adjustment to fair market value.

- 11. To the extent the partner or member withdraws his or her investment in the partnership or LLC there is generally no gain or loss. Rather it reduces the outside basis by the amount of the withdrawal. There are some exceptions to this rule and those exceptions include the following:

C. Outside Basis

- A partner or member receives a cash distribution in excess of their individual outside basis. The excess gain is reported and is taxed. It should be noted that a reduction of liabilities is a deemed cash distribution. (See Section 731(a)(1) and 752(b))

- A partner or member receives a property distribution in which the adjusted basis to the partnership (inside basis in the property) exceeds the partner members outside basis. In this case the property distributed takes a substituted basis equal to the outside basis amount. The gain is deferred until the partner member subsequently disposes of the property outside the partnership or LLC. (See Section 732)

- A partnership or LLC interest is disposed of and the partner or member receives more or less than his after-tax investment in the partnership or LLC. A gain or loss would be reported (See Section 731 and 741)

D. Tax Basis Capital Accounts

- **1. New Partners**. When a new partner purchases an interest in a partnership from another partner, the seller partner gets the money not the partnership. The new partner's capital account will have the same value as the capital account of the selling partner's capital account just before the sale.

- a. If the selling partner had a Section 754 election in place the amount of the step up in basis less additional depreciation or amortization allocated to the selling partner during his time as partner should not be included in the new partner's beginning capital account value.

D. Tax Basis Capital Accounts

- b. However, if the new partner makes a Section 754 election, the partner should get a step up in basis credited to his capital account in the book value of assets are stepped up by comparable amount and the additional depreciation and amortization resulting from the step up is allocated specifically to the new partner share of profit or loss for the tax year.

D. Tax Basis Capital Accounts

- **2. After Acquisition**. A partner that acquires its partnership interest by transfer from another partner either by purchase or in a non-recognition event has a tax account immediately after the transfer equal to the transferring partner’s tax account immediately before the transfer except no portion of any Section 743 (b) basis adjustment the transferring partner may have is transferred to the partner acquiring the interest.

- a. If a Section 754 election is in effect, the partnership increases or decreases the tax capital account applied by the transferee partner by an amount equal to the positive or negative adjustment to the tax basis of the partnership under Section 743 (b) as a result of the transfer.

- 3. In general, to the extent that a partner withdraws there after-tax investment in a partnership there is no gain or loss. It merely reduces the outside basis by the amount of the withdrawal.

- 4. There are some exceptions to that rule which include the following:

D. Tax Basis Capital Accounts

– If a partner receives a distribution of cash in excess of outside basis, the partner must report a gain for the excess. Reduction of liabilities is considered a deemed cash distribution. (see section 731 and section 752)

– If the partner receives a distribution of property in which the adjusted basis to the partnership is more than the partners outside basis in his or her partnership interest then the property takes a substituted basis equal to the outside basis amount. The gain is deferred until the partner later disposes of the property outside of the partnership. If a partnership interest is disposed of and the partner receives more or less than his or her after-tax investment in the partnership partner will report a gain or loss respectively.

D. Tax Basis Capital Accounts

- 5. Taxable Distributions in Excess of Basis refers to the current your basis calculated as beginning year outside basis plus current year income and gain items less current year distributions. Any loss or deduction on Schedule K – 1 is ignored until the partners basis after current year distributions has been determined.

E. Economic Substance Doctrine and Partnership Basis Shifting Transactions – Revenue Ruling 2024 – 14

- 1. The service address the application of the economic substance doctrine to certain basis shifting transactions which result from the rules of Subchapter K. The Service identified the issue as taxpayers using the rules applicable to partnerships to create disparity between inside and outside basis.

- 2. The Partnership and partners often used Section 732, 734 (b), 743 (b) to shift basis.. Sometimes the shifting can result in basis being retained in non-depreciable property being shifted to proper that qualifies for depreciation. As well as the transaction producing less gain upon final disposition due to the increase in basis.

E. Economic Substance Doctrine and Partnership Basis Shifting Transactions – Revenue Ruling 2024 – 14

- 3. Rev. Rul. 2024-14 holds that the economic substance doctrine applies to disallow tax benefits in three scenarios involving a related-party partnership that engaged in transactions with a view to creating a disparity between inside and outside basis that resulted in a basis adjustment to property that either generated increased cost recovery deductions with respect to the property or reduced gain or increased loss upon the sale of the property.

- a. The facts describing each scenario stipulate that the transaction was undertaken to achieve cost savings by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

E. Economic Substance Doctrine and Partnership Basis Shifting Transactions – Revenue Ruling 2024 – 14

- 4. The revenue ruling notes that Congress intended to preserve parity between inside and outside basis to prevent unintended tax benefits and detriments, but that it did not intend to allow that taxpayers be able to avoid or indefinitely defer taxation altogether by creating basis disparities through contributions or distributions of property or through allocations of tax items.

- a. The revenue ruling then analyzes economic substance doctrine case law and concludes that the changes in economic position described in the three scenarios were not meaningful apart from the Federal income tax effects. Finally, the revenue ruling holds that the transactions lacked substantial purpose and that the cost savings were insubstantial in relation to the reduction in the aggregate Federal income tax liability of the related parties.

- 5. The ruling also notes that the transactions could be subject to other anti-abuse doctrines, including the partnership anti-abuse rule, the section 704(c) anti-abuse rule, the substance-over-form doctrine, or the step-transaction doctrine

F. Notice 2024 – 54 Proposed Regulations and Guidance on Basis Shifting Transactions by Related Parties

- 1. The IRS has issued guidance regarding basis shifting transactions used by related parties. The Service will propose two sets of regulations to prevent tax avoiding basis shifting maneuvers within partnerships that involve related parties.

- 2. The Service intends to propose regulations under Section 732, 734(b), 743(b), and 755 that would do the following:
  - Provide the required method of recovering adjustments to the bases of property held by a partnership, property distributed by a partnership, or both, arising from covered transactions;
  - Provide rules governing the determination of gain or loss on the disposition of such basis-adjusted property; and
  - Include similar transactions involving tax-indifferent parties rather than related parties.

F. Notice 2024 – 54 Proposed Regulations and Guidance on Basis Shifting Transactions by Related Parties

- 3. In addition, the IRS intends to propose regulations that would provide for single-entity treatment of members that are partners in a partnership, so that covered transactions cannot shift basis among group members and distort group income.

- 4. The proposed regulations would also contain regulations that would flag certain partnership transactions involving related parties for closer scrutiny by identifying them as transactions of interest which would in essence be a reportable transaction.

IX. Section 754 Election

A. General

- 1. When a partnership distributes property or a partner transfers his or her interest, the partnership can elect under Section 754 to adjust the basis of partnership property.
- 2. A Section 754 election allows a step-up or step-down in basis under either Section 734(b) or Section 743(b) to reflect the FMV at the time of the exchange.
- 3. This election has the advantage of not taxing the new partner on gains or losses already reflected in the purchase price of his or her partnership interest.

B. Regulations Streamline Partnership Basis Elections – TD 9963

- 1. Under final regulations issued by the IRS and Treasury, partnerships electing to adjust the basis of partnership property under Section 754 will not have to include a partner's signature on their election statement.
- 2. Partnerships generally may make the election in the case of a distribution of property in the manner provided in Section 734 or a transfer of a partnership interest under Section 743.
- 3. The election applies to all distributions of property and all transfers of a partnership interest in the partnership during the tax year with respect to which it is filed and for all subsequent tax years.
- 4. The final regulations are effective beginning Aug. 5, 2022, although taxpayers have been able to rely on the proposed regulations previously.

C. Revoking a Section 754 Election

- 1. A partnership that wants to revoke its Sec. 754 election should file its revocation request using Form 15254, Request for Section 754 Revocation, which must be filed no later than 30 days after the close of the partnership's tax year and must state the reason(s) for requesting a revocation.

- 2. 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.

- 3. Before a Section 754 election is finalized, it must be reviewed and approved by a manager and the Chief Counsel's office. This guidance applies to any partnership, whether subject to TEFRA, the BBA, or separate deficiency proceedings.

X. Limited Partners and Self Employment Tax – Functional Test Determination for Limited Partners

A. Overview

- 1. The Tax Court has recently indicated that in determining whether a distributive share of partnership profits under a state law limited partner qualifies for the exception for self-employment tax, the limited partners function and role in the partnership must be examined and determined.

- 2. Section 1401(a) imposes a tax on the self-employment income of individuals. Self-employment income is defined as "the net earnings from self-employment derived by an individual … during any taxable year."4 Sec. 1402(a) in turn defines net earnings from self-employment as:

- The gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member.

A. Overview

- 3. In essence, the sections require partners to include the distribution of partnership income profits and net

- Earnings from self-employment. However, section 1402 (a) (12) contains an exception to the imposition of self-employment tax for the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described under Section 707 (c) to that partner for services actually rendered to or on behalf of the partnership to the extent those payments are established to be in the nature of renumeration for such services.

- 4. The legislative history of this provision reveals that Congress intended to exclude distributive shares of partnership net income of limited partners from the Social Security system exempting them from self-employment taxes but also precluding it from generating any future retirement benefits, the value of which at the time was considered to exceed the incurrence of self-employment tax. This change under a recent tax case

Example

- **Soroeban Capital Partners, LP, 161 TC No. 12**. The limited partnership made guarantee payments and distribute ordinary income to its limited partners. On its tax returns for the years at issue, the partnership reported as net earnings from self-employment it's guaranteed payments to limited partners plus the general partner's share of ordinary income. The partnership excluded from his computation of net earnings from self-employment the ordinary income distributed to the limited partners. The IRS increased the limited partnership's net earnings from self-employment to include the share of order income allocated to the limited partners. The services position is that they were limited partners in name only. The partnership argued first that the ordinary income allocated to the limited partners is excluded from its e net earnings from self-employment because those partners are under state law limited partners. In addition, the partnership indicated the Tax Court could not inquire into the functional roles of the limited partners in a partnership level proceeding. The Tax Court noted that partnerships are required to include in their computation of net earnings from self-employment the distributive share of their partner's income.

Example

- However, Section 1402 (a) (13) excludes from the net income from self-employment computation a limited partner's distributive share of income. The Tax Court determined that the congressional intent for the limited partner exception was earnings associated with an investment nature with the limited partner is functioning as a limited partner. To ascertain whether the earnings allocated to limited partners were of an investment nature, the court must inquire as to the function and roles of the limited partners. Since the partnership was recorded Catholic net earnings from self-employment at the partnership level, any adjustment to the calculation would be made in a partnership level proceeding. In essence, the court has jurisdiction to determine whether ordinary income allocated to limited partners is to be excluded from net earnings from self-employment in the current partnership level proceeding. The Court rejected the partnership's argument that since it is a state law limited partnership and slimmer partners are characterized as such under state law that there distributive shares of income are excluded from an earnings is subject to self-employment tax. The court found that before the partners distribute shares to be excluded the court must ascertain whether the limited partners are functioning in that capacity as limited partners.

XI. Self-Employment Tax v Distributions

A. General

- 1. A partners net earnings from self-employment includes both the distribution and share of income from the partnership any guarantee payments for services rendered to the partnership or for the use of capital by the partnership to the extent the payments are determined without regard to the income from the partnership.(See 1.402(a) – 1).

- 2. In determining a partners net income for self-employment tax purposes, the guarantee payment received by the partner for the performance of services or for the use of capital is offset by the partner's distributive share of loss from the partnership.

A. General

- 3. In order for the partner’s distributive share of income to be considered as self-employment income, the partnership must be engaged in a trade or business. This is a fact and circumstance examination. It should be noted, that it is possible for partner’s distributive share of partnership income to be subject to self-employment tax and the passive activity rules under Section 469 in the event the partner does not materially participate in the activities of the partnership.

- . The general rule has been that of a partner owns a limited partnership interest and receives a distributive share from the partnership that income is not subject to self-employment tax. However, if limited partner sees a guarantee payment the performance of services obviously such is subject to self-employment tax.

A. General

- 5. For partner's distributive share of income in a partnership to be considered subject to self-employment income, the partnership must be engaged in a trade or business. An exception is provided for real estate rentals. The partnership is not engagement trade or business, distributive share is obviously not subject to self-employment tax. This appears to be the case even if the partner is passive in nature. This matter could be confusing in association with LLCs.

B. LLC Members

- 1. Other than guaranteed payments, when members receive payments for services performed for a limited liability company (LLC) that is classified as a partnership for federal income tax purposes, the first issue is to determine whether the member is performing the services in the capacity as a member or as a third party.

- 2. When services are performed outside the member's capacity as a member, the transaction is treated for tax purposes as occurring between the LLC and a third party (Sec. 707(a)). Payments ,other than guaranteed payments, received for services performed in the member's capacity as a member are generally treated as a distribution of the member's share of LLC income.

- 3. When payments made to a member acting in the capacity as a member are treated as distributions of LLC income, the payment is a current distribution under Sec. 731, income is generally recognized only to the extent the distribution exceeds the member's basis in the LLC.

B. LLC Members

- 4. The member reports the distributive share of income (whether distributed or not) in its tax year that includes the LLC's year end. This may result in the member's reporting income before payment is received. The timing rule for recognizing guaranteed payments is similar.
- 5. If payments are made to a member acting outside the capacity as a member, a cash-basis member does not report income until the payments are received.
- 6. In addition to the member's timing for income recognition, whether services are performed as a member or as a third party affects the LLC.

Example

- An LLC is formed to design and construct an office building. Assume one of the original members is an architect who contributed $50,000 cash (10% of all contributed capital) for a 10% interest in all LLC items. If this member provides the necessary architectural services for the project in his capacity as a member and receives no payment (other than his allocable share of LLC income and cash flow), the value of his services is not capitalized to the cost of the building or deducted by the LLC. If the same individual had been paid a fee in addition to his distributive share of LLC profits (acted outside his capacity as a member) to perform the architectural services, the LLC would be required to capitalize the fee paid as part of the cost of the building.

B. LLC Members

- 7. The intent of the parties and the structure of the transaction generally determine if a member is treated as performing services as a nonmember.
- 8. If a member performs the same type of services the LLC renders, he or she is often acting in his or her capacity as a member. Additionally, he or she is most likely acting as a member if he or she does not receive any payment (other than distributions of income allocated to him or her under the Sec. 704 rules) for services performed for the LLC.
- 9. In certain situations, Sec. 707(a)(2)(A) provides a disguised-payment-for-services rule requiring payments that would otherwise be treated as distributions of the member's share of LLC income to be treated as a payment for services made to a nonmember.
- 10. The courts generally have held that the determination of whether a partner is acting in a nonpartner/nonmember capacity is based on the facts and circumstances.

XII. BBA Procedures

A. Overview

- 1. The Bipartisan Budget Act of 2015 (BBA), P.L. 114-74, replaced the TEFRA procedures with the BBA procedures, which established a new framework for auditing, adjusting, assessing, and collecting tax from partnerships. The BBA procedures streamlined the audit process for partnerships by allowing audits, adjustments, and payments to all occur at the partnership level.

- 2. Partnerships were given the right to elect, in the form and manner prescribed by the IRS, into the BBA procedures for years beginning after the BBA's enactment and before 2018. The IRS issued Regs. Sec. 301.9100-22, containing the rules for making an early election into the BBA procedures. The regulation specified that the election was valid only if it met the requirements of the regulation, and an otherwise valid election would be invalid if it frustrated the purposes of the BBA.

B. Representation in Making Election

- 1. Among the requirements for making the election the regulations indicate that in making the election the partnership must make a representation that the partnership has sufficient assets and reasonably anticipates having sufficient assets to pay a potential imputed underpayment with respect to the partnership taxable year that may be determined under examination. (Regulation Section 301.9100 – 22 (b) (2) (ii) (D) (4))

Example

- **SN Worthington holding LLC v. Comm., 162 TC 10**. SN Worthington Holdings LLC is a limited liability company (LLC) classified as a partnership for federal income tax purposes. In 2017, it filed Form 1065, U. S. Return of Partnership Income, for 2016. In October 2018, the IRS sent the LLC a letter notifying it that the Service was auditing its 2016 partnership return and that it could elect into the BBA partnership audit procedures. The letter stated that it must make the election within 30 days of the date of the letter. SN Worthington timely submitted Form 7036, Election Under Section 1101(g)(4) of the Bipartisan Budget Act of 2015, signed under penalties of perjury. In Form 7036, the LLC made the representation, as required by Regs. Sec. 301. 9100-2(b)(2)(ii)(E)(4). Soon after receiving the election, the IRS questioned that representation and sent SN Worthington a letter stating that after review of the return they did not meet the requirement to have sufficient assets to pay any potential imputed penalty.

Example

- The letter further indicated that if the taxpayer disagreed with the IRS's determination it could submit supporting documentation within 30 days. SN Worthington did not respond to the letter, so the IRS sent a second letter notifying the LLC that it had determined that the election was invalid because the LLC had not provided proof of sufficient available assets to pay the potential imputed tax liability and also because the election was not signed by the tax matters partner or an individual authorized to sign the partnership return for the tax year under examination. SN Worthington also did not respond to the second letter but subsequently communicated with the IRS and signed documents that referred to the TEFRA procedures.

Example

- In June, 2020 , SN Worthington informed the IRS that it believed that the examination was being conducted under the wrong procedures. It sent a fax to the IRS requesting to be a part of the Small Business/Self-Employed Fast Track Settlement program but also addressed its position that the IRS should not have been examining the return under TEFRA procedures because the LLC had elected into the BBA procedures. The letter discussed the LLC’s reasons why it disagreed with both of the reasons the IRS gave for determining the election into the BBA procedures was invalid, stating that there is no requirement that a taxpayer provide proof of sufficient assets to pay an imputed tax liability and the Election was signed by the individual who, in fact, signed the Taxpayer’s partnership return for the taxable year under examination. he IRS denied the fast-track settlement request without addressing SN Worthington’s claim that the return was being examined under the wrong procedures.

Example

- In August 2020, the IRS issued an FPAA to SN Worthington, determining adjustments to its 2016 return. The LLC timely filed a petition challenging the IRS's determinations in Tax Court. In its petition, SN Worthington LLC argued that its election into the BBA procedures was valid because the election complied with the plain text of Regs. Sec. 301.9100-22. It also argued that because the IRS did not have the authority to request additional information from SN Worthington that was not stated in or required by the regulation, the LLC's failure to provide additional information asked for by the IRS did not make the election invalid. Alternatively, SN Worthington contended that even if the IRS had the authority to request additional information, the LLC had already provided information proving it had enough assets to pay an imputed underpayment. Thus, the IRS's denial of SN Worthington's election was unreasonable, arbitrary, and capricious.

Example

- The Tax Court held that SN Worthington had satisfied the requirement to make a representation that it had, and anticipated continuing to have, enough assets to pay a potential imputed underpayment for the year in issue, so its election into the BBA procedures was valid. Thus, the FPAA issued to the LLC was invalid, and the court lacked jurisdiction to hear the case. The Tax Court explained that, under its own precedent, taxpayers make valid elections when they comply with the plain text of the election requirements. The manner for making an election can be set forth in various ways, including by statute or by IRS regulation, but once the manner for making an election is established, the IRS may not add ad hoc requirements. Moreover, when the IRS is determining whether a taxpayer has made a valid election, it may not require the taxpayer to meet more stringent requirements than authorized in the provision that authorizes the election. The Tax Court found that SN Worthington had satisfied the requirement that it represent that it had sufficient assets to satisfy an imputed underpayment by submitting a signed Form 7036.

Example

- The IRS argued that to make a valid election into the BBA procedures, the partnership must establish (and not merely represent) that it has sufficient assets to satisfy an imputed underpayment. It contended that this was necessary to meet the requirement under Regs. Sec. 301.9100-22(a) that an election into the BBA procedures is not valid if it frustrates the purposes of the BBA. The court found that the regulation does not define or describe the purposes of the BBA or what would frustrate those purposes. The court reasoned that the BBA procedures themselves refuted the IRS's contention that it would frustrate the purposes of the BBA for a partnership to elect early into the BBA procedures when it does not have sufficient assets to pay an imputed underpayment that may become due. According to the court, the BBA procedures contemplate this situation because, under them, if a partnership does not promptly pay an imputed underpayment, the IRS can assess and collect from the partners of the partnership their proportionate shares of the imputed underpayment (Sec. 6232(f)(1)(B)).

XIII. Late Filing Penalties

A. Failure to File - Partnerships and S Corporations

- 1. In case of any return required to be filed in 2025, the dollar amount used to determine the amount of the penalty for failing to file is $245 per partner/shareholder for timeframe not exceeding 12 months in that particular tax year. (Rev. Proc. 2023 – 34)

- 2. In case of any return required to be filed in 2026, the dollar amount used to determine the amount of the penalty for failing to file is $255 per person per partner for a timeframe not exceeding 12 months in that particular tax year. (See Rev. Proc. 2024 – 40)

B. Rev. Proc. 84-35: Small Partnership Abatement

- 1. If a partnership failed to timely file its IRS Form 1065 and you get penalized by the IRS you should consider seeking relief from or abatement of this penalty under IRS Revenue Procedure 84-35.
- 2. Often the revenue procedure is associated with either an S corporation or partnership failing to file the return on time.
- 3. Small partnerships that file late returns may qualify under Rev. Proc. 84-35 for an abatement of the late-filing penalties. The partnership must meet the following requirements:

B. Rev. Proc. 84-35: Small Partnership Abatement

- The partnership has to be a domestic partnership,
- Have 10 or fewer partners (husband and wife and their estate are treated as one partner),
- All partners have to be natural persons (other than a nonresident alien) or an estate of a deceased partner,
- Each partner's share of each partnership item has to be the same as their share of every other item,
- All partners need to have timely filed their income tax returns, and
- All the partners need to have fully reported their share of the income, deductions, and credits of the partnership on their timely filed income tax returns.

SECTION XVI:

EMPLOYMENT TAX UPDATE

I. IRS Releases 941 – X Instructions

A. Overview

- 1. The IRS has released a new version of the instructions for Form 941-X (Adjusted Employers Quarterly Federal Tax Return or Claim for Refund) that was revised previously in early 2023.The revised instructions contain a number of changes to the qualified small business payroll tax credit for increasing research activities for tax year 2023 and beyond.

- 2. The Form 941-X instructions have been updated to reflect changes to the credit for increasing research activities for tax year 2023 and beyond. Under the Inflation Reduction Act of 2022 (IRA), qualified small businesses may now elect to claim up to $500,000 against payroll taxes beginning in 2023. The credit may be used to first reduce the employer share of Social Security tax up to $250,000 per quarter, and the remaining $250,000 against the employer share of Medicare tax. Any amount not used against Social Security and Medicare taxes may be carried forward to the next quarter.

A. Overview

- 3. Employers must use Form 8974 to determine the amount of the credit for the current quarter.
- 4. April Version. The April version of Form 941 – X will allow for electronic filing as part of the modernized e-file system.

II. Employer Retention Credit Update

A. Warning Signs Employment Retention Credit Claims may be Incorrect. – IR 2024 – 39. T

- 1. The IRS has identified seven warning signs that employee retention credit claims may be questionable and are urging businesses to resolve incorrect claims. Originally, this pertain to the deadline for voluntary disclosure of March 22, 2024. However, the service continues to advocate that employers correct these claims. The claims include the following:
  - To Many Quarters being claimed
  - Government Orders that don't qualify
  - To Many employees and wrong calculations
  - Business citing supply chain issues
  - Business Claiming ERC for too much for a tax period
  - Business not paying wages or did not exist during the eligibility timeframe and
  - Promoter saying there is nothing to lose.

B. Volunteer Disclosure Program Ended March 22, 2024.

- 1. The program allows eligible participants to repay incorrect ERC's at an 80% rate. There is current discussion on reinstituting the program.

- 2. Generic Legal Advice Memorandum 2024 – 1. The IRS stated that third-party payers who provide and pay employees for other businesses are liable with their client for false claims of the Employee Retention Credit.

C. Deadline to Amend

- 1. Generally, you may correct overreported taxes on a previously filed Form 941 if you file Form 941-X within 3 years of the date Form 941 was filed or 2 years from the date you paid the tax reported on Form 941, whichever is later.

- 2. You may correct underreported taxes on a previously filed Form 941 if you file Form 941-X within 3 years of the date the Form 941 was filed. We call each of these time frames a "period of limitations."

- 3. For purposes of the period of limitations, Forms 941 for a calendar year are considered filed on April 15 of the succeeding year if filed before that date.

D. Documentation In The Event Of An Audit

- 1. On March 20, 2023, a director at the IRS conducted an online session to discuss potential problems and scams with respect to the employee retention credit. During the teleconference, the representative indicated in the event of an examination certain documentation would be required including the following:
  - ERC Worksheets 2 and 4
  - Proof the business is classified as a recovery startup.
  - List of Employees paid wages for the ERC claimed and whether they are related to the employer.
  - Proof that the business was shut down pursuant to a state, federal County or local order.
  - Documentation that the employer is an eligible employer
  - Records the employer relied upon to determine whether more than a nominal portion of its operations were suspended due to a government order or whether government order had more than a nominal effect on its business operations. (LuPone – there's no definition of nominal year)
  - Any significant decline in gross receipts must be documented
  - documentation to show the employer determine the amount of allocable qualified health plan expenses.
  - Copies of all Form 941's and 941-Xs.

E. Withdrawal of ERC Claim – IR 2023 – 193

- 1. Taxpayers who filed an ERC claim may withdraw their submission. The process is option associated to help small business owners and others who may have been pressured or misled by marketers or promoters into filing in eligible claims.

- 2. The reason for the withdraw will be obviously to avoid the imposition of future repayment and assessment of penalties and interest.

- 3. The following employers may withdraw an ERC claim:
  - Employers that claimed the ERC on an adjusted employment return (Forms 941-X, 943-X, 944-X, CT-1X).
  - Employers that filed the adjusted return only to claim the ERC, and made no other adjustments.
  - Employers that want to withdraw the entire amount of their ERC claim.
  - Employers whose claim has not yet been paid or employers who have not yet cashed or deposited the refund check.

E. Withdrawal of ERC Claim – IR 2023 – 193

- 4. Employers not eligible to use the withdrawal process may reduce or eliminate their ERC claim by filing an amended return.

- 5. Withdrawal process depends on whether the employer has been notified that they are under audit or if the claim was submitted on their behalf by payroll service provider.

- 6. For employers who submitted an ERC themselves and have not received, cashed, or deposited the refund and have not received notification that they are under audit, a withdrawal request may be faxed to the IRS. Mailed requests are also accepted but processing may be delayed. To withdraw the claim, the employer must submit a copy of the adjusted return with the claim that is to be withdrawn and:
  - Write "withdrawn" in the left margin of the first page of the copy of the amended return;
  - Have the authorized person sign and date the first page of the copy in the right margin;
  - Fax the signed copy to the irs's\ ERC withdrawal line found at IRS.Gov/withdrawmyerc; and
  - Retain a copy for tax records

E. Withdrawal of ERC Claim – IR 2023 – 193

- 7. Employers who are not under audit and have received a refund, but have not yet cashed or deposited it, must complete the same process as above, but mail the check and the copy of the amended return to the IRS at the mailing address provided at IRS.gov/withdrawmyerc. The employer should write "void" on the endorsement section of the refund check and include a note that says "ERC Withdrawal" with a brief explanation for the return of the check. A copy should be retained for tax records.

- 8. For employers who have been informed they are under audit, a withdrawal request must be submitted to the assigned examiner or in a response to the audit notice if no examiner is assigned.

E. Withdrawal of ERC Claim – IR 2023 – 193

- 9. For employers who used a payroll service provider to file their ERC claim, they should contact the payroll company to determine if the provider will submit the withdrawal request on their behalf. This will depend on whether the payroll company submitted ERC claims on an individual basis or batched with other clients.

- 10. Employers that submit a withdrawal request will receive a letter from the IRS whether their request is approved or rejected. If a withdrawal is accepted, the employer may need to submit an amended return.

- 11. The IRS also indicated that they are developing a settlement program that will allow taxpayers to make repayments for improperly received ERC payments that have been cashed or deposited. The settlement program has not been finalized at the time of the presentation.

II. Work Life Referral Services – IR 2024 – 110; Fact Sheet 2024 – 110.

A. Overview

- 1. The IRS has issued frequently asked questions (FAQs) on the tax treatment of work-life referral services, sometimes called caregiver and caretaker navigation services, which are employer-funded benefits that help employees find resources and support for personal, work, or family challenges.

- 2. These services are typically integrated into employee assistance programs or bundled with other employer services and can include guidance on accessing child and elder care, health care, financial and legal services, and assistance with related paperwork and administrative tasks.

- 3. In the announcement, the IRS provides that these services are de minimis fringe benefits, exempt from income and employment taxes (FICA, FUTA, and income tax withholding). The guidance also notes that the IRS will not rely on FAQs to resolve cases and warns that if an FAQ provides an inaccurate statement of the law, the law will control the taxpayer's liability

III. Independent Contractor Issues

A. Federal Rule

- 1. Whether a worker is an independent contractor or employee generally is determined by whether the enterprise he works for has the right to control and direct him regarding the job he is to do and how he is to do it. Under the common-law rules (so-called because they originate from court cases rather than from the Code), factors used to determine if an individual is a common law employee are:
  - The degree of control exercised by the principal;
  - Which party invests in work facilities used by the individual;
  - The opportunity of the individual for profit or loss;
  - Whether the principal can discharge the individual;
  - Whether the work is part of the principal's regular business;
  - The permanency of the relationship;
  - The relationship the parties believed they were creating; and
  - The provision of employee benefits.

A. Federal Rule

- 2. Section 530 is a relief provision that terminates a taxpayer’s employment tax liability with respect to an individual not treated as an employee if three statutory requirements are met:

A. Federal Rule

- **Reporting Consistency** – The taxpayer must have timely filed the requisite information returns consistent with its treatment of the worker as a non-employee. (For example, if the taxpayer claims the worker is an independent contractor, Forms 1099 must have been filed for the taxable years at issue). If no information return requirement exists, relief will not be denied on the basis that the return was not filed. (For example, if the taxpayer claims the worker was a volunteer, no information returns would be required). (Rev. Proc. 85-18, 3.03(B); Rev. Rul. 81-224)
- **Substantive Consistency** – If the taxpayer or predecessor treated the worker, or any worker holding a substantially similar position, as an employee at any time after December 31, 1977, the taxpayer will not be eligible for relief. See: Section 530(e)(6); Rev. Proc. 85-18; Rev. Rul. 83-16, Rev. Rul. 84-161. This is a facts and circumstance determination. A review of the day to day services performed and comparison of the job functions must be done. The mere fact of similar job titles or categories alone are not sufficient, and
- **Reasonable Basis** – The taxpayer must have reasonably relied on one of the following three "safe harbors": 1) prior audit; 2) judicial precedent; or 3) industry practice. Taxpayer must have relied on the alleged authority at the time the employment decisions were being made for the periods at issue. The statute does not allow ex post facto justification.

A. Federal Rule

- 3. Section 530 does not extend to the worker, who may still be liable for the employee share of FICA, not self-employment tax. This is consistent with the IRS Volunteer Classification Settlement Program (VCS P) under this volunteer program and application by the employer must be completed which is Form 8952 meeting the qualifications discussed herein.

- 4. This provision applies to taxpayers in cases involving determinations of employment status, i.e. worker classification cases.

A. Federal Rule

- 5. Section 530 provides a permanent cure for an organization’s employment tax liabilities relating to a particular group(s) of workers. It is not necessary for the business to claim Section 530 relief for it to be applicable.

- 6. Section 530 applies only to worker classification issues; Section 530 does not apply to wage issues.

Example

- **Cardiovascular Center LLC V. Comm., TC Memo 2023 – 64**. The Service determined that medical practice improperly treated its medical assistants and office manager as independent contractors for number of years was upheld by the Tax Court. The evidence showed that medical assistants and office manager were common law employees. Those factors included that taxpayer exercised significant control over medical assistants and office manager, in that its company officer supervised, set office procedures and controlled amount they were paid. Also, taxpayer provided medical assistants and office manager supplies required to complete their jobs. The workers had no opportunity for profit outside of their wages and they were integral to taxpayer's business and stayed with taxpayer for several years. The LLC did not relief under Section 530 because it didn't establish reasonable basis for not treating workers as employees and failed to file Forms 1099-MISC.

B. Gig Workers

- 1. Individuals who perform "gig" work part time or full time may be treated as independent contractors running their own business.
- 2. A “gig worker” is on-demand labor that does not follow a fixed schedule. Such jobs are often found through an app or website. Examples include driving for Uber, Lyft, selling goods online (Etsy, eBay), renting out property (Airbnb, Vrbo), and providing services such as web design, house sitting, or dog walking.
- 3. Income from gig work is taxable, whether an individual receives an information return.

B. Gig Workers

- 4. Notice 2023 – 10. Originally, to become effective beginning in 2022, Form 1099-K: Payment Card and Third-Party Network Transactions, to anyone who was paid more than $600 through that platform. Previously the reporting threshold was $20,000 received through the platform from more than 200 transactions. The delay was due to transition matters.

- 5. Gig workers who are independent contractors are considered to be self -employed,

C. Department of Labor issued New Guidance on Determining Employee v. Independent Contractor Status – RIN 1235-AA43

- 1. A new U.S. Department of Labor (DOL) rule offers guidance for employers related to determining whether to classify a worker as an employee or independent contractor under the Fair Labor Standards Act (FLSA). The new regulation returns to an "economic reality test" for determining workers' status and rescinds the 2021 Independent Contractor Rule.

- 2. The new economic reality test calls for employers to consider six factors when determining whether a worker should be treated as an employee or independent contractor, without any "predetermined weight" given to any one factor:
  - Any opportunity for profit or loss a worker might have;
  - The financial stake and nature of any resources a worker has invested in the work;
  - The degree of permanence of the work relationship;
  - The degree of control an employer has over the person's work;
  - Whether the work the person does is essential to the employer's business; and
  - A factor regarding the worker's skill and initiative.

C. Department of Labor issued New Guidance on Determining Employee v. Independent Contractor Status – RIN 1235-AA43

- 3. The final rule provides detailed guidance regarding the application of each of these six factors. No factor or set of factors among this list of six has a predetermined weight, and additional factors may be relevant if such factors in some way indicate whether the worker is in business for themself (i.e., an independent contractor), as opposed to being economically dependent on the employer for work (i.e., an employee under the FLSA). A worker cannot voluntarily waive employee status and choose to be classified as independent contractor.

- 4. This final rule differs from the guidance provided in the 2021 Independent Contractor Rule in several ways:

C. Department of Labor issued New Guidance on Determining Employee v. Independent Contractor Status – RIN 1235-AA43

- 4. This final rule differs from the guidance provided in the 2021 Independent Contractor Rule in several ways:
  - Returns to a totality-of-the-circumstances economic reality test, where no single factor or group of factors is assigned any predetermined weight;
  - Considers six factors (instead of five), including the investments made by the worker and the potential employer;
  - Provides additional analysis of the control factor, including a detailed discussion of how scheduling, supervision, price-setting, and the ability to work for others should be considered when analyzing the nature and degree of control over a worker;
  - Returns to the Department's longstanding consideration of whether the work is integral to the employer's business (rather than whether it is exclusively part of an "integrated unit of production");
  - Provides additional context to some factors, including a discussion of exclusivity in the context of the permanency factor and initiative in the context of the skill factor; and
  - Omits a provision from the 2021 Independent Contractor Rule which minimized the relevance of an employer's reserved but unexercised rights to control a worker.

C. Department of Labor issued New Guidance on Determining Employee v. Independent Contractor Status – RIN 1235-AA43

- 5. The new rule is effective March 11, 2024

D. Texas and the Independent Contractor Rule

- 1. Texas does NOT follow the federal independent contractor rule.
- 2. In Texas, if a worker’s service fits the TUCA definition of employment as outlined in Section 201.041, the individual is considered an employee.
- 3. The law defines employment as a service performed by an individual for wages under an express or implied contract for hire, unless it is shown to the satisfaction of the Commission that the individual’s performance of the service has been and will continue to be free from control or direction under the contract.

D. Texas and the Independent Contractor Rule

- 4. TWC looks at three essential elements of the definition of employment. They are service, wages, and direction and control. Direction and control can be present in an employment relationship even if the employer does not exercise direction and control, but retains the right to do so.

- 5. TWC uses a 20-point comparative approach which is attached.

IV. Responsible Party Issues- Section 6672

A. Rule

- 1. Section imposes the trust fund recovery penalty on any person who:
  - Is responsible for collecting, accounting for, and paying over payroll taxes; and
  - Willfully fails to perform this responsibility. The amount of the penalty is equal to the amount of the tax that was not collected and paid. The penalty is imposed on a “responsible person.” A “responsible person” may be anyone in a business entity who has the duty to collect, account for, or pay over the tax.
- 2. The burden is on the taxpayer to show that they are not a responsible party or did not act willfully in failing to collect and pay the taxes.

A. Rule

- 3. The service must disclose in writing the name of any person whom it is determined to be liable for the penalty and whether it has attempted to collect the penalty from such other person and the general nature of the collection activities and the amount collected in the event the service holds parties jointly and severally liable.

- 4. A "responsible person" is someone with significant, not necessarily exclusive, control over the company's finances. Significant control is the final or significant word over which bills or creditors get paid. The determination of whether one is a responsible person within the meaning of IRC § 6672 is a matter of status, duty, and authority. Courts have recognized the following non-exhaustive five characteristics as being indicative of a person's status as a "responsible person":
  - Employment as a corporate officer;
  - Control over financial affairs;
  - The authority to disburse corporate funds;
  - Ownership of stock; and
  - The ability to hire and fire employees

Examples

- **United States v. Olson, 133 AFTR2d 2024-1342**. The Seventh Circuit Court of Appeals reversed an Indiana Federal District Court and held that a plumbing company that failed to pay over payroll taxes as well as income taxes could be enjoined and ordered to pay IRS ahead of creditors.

- **US v. Colasuonno, No. 7:2021 CV 10877 (SD NY 2024)**. The taxpayer failed to pay an assessment for not collecting trust fund taxes. Was no evidence presented to support the taxpayer's position that the amount was incorrect the taxpayer partly owned a corporation and as owner he failed to collect, account for and pay over trust fund taxes from multiple quarters. The taxpayer conceded to not collecting the trust fund taxes and knowingly and allow false Form 941 returns to be filed. As part of the effort to shield the liability, the taxpayers wrote checks for wages owed to his employees to another company. The deposit monies were withdrawn to pay the quote company employees in cash. The taxpayer failed to submit any evidence that the IRS was improperly targeting him are using illegal criteria in choosing to file suit against him under the trust fund penalty provisions.

Examples

- **Powell v. IRS, 133 AFTR2d 2024-1212**. A Pennsylvania Federal District Court determined that the general manager of an auto body shop was not personally liable as he was not an owner, director or officer and his signature authority was used only per direction of the owner and, in any event, he was unaware of the tax liability.

- **Taylor v. Comm., TC Memo 2024-33**. The Tax Court found that the sole owner and CEO of a management consulting company was a responsible person liable for paying over payroll taxes, rejecting his argument that he did not comprehend mathematical concepts and had delegated authority to his accountant who embezzled company funds and noting that the reimbursed funds from the accountant were used for purposes other than paying back taxes.

B. Procedure for Determination of Responsible Party

- 1. If the IRS wishes to ascertain whether the client is a responsible party, they will request an interview with the client. This is known as a 4180 interview because the agent asked questions from Form 4180: Review of Interview with Individual Relative to Trust Fund Recovery Penalty.

- 2. Form 4180 generally asked questions regarding the client’s duties, functions. Specifically, it asked the following:

B. Procedure for Determination of Responsible Party

- Job title and how the client is associated with the business
- Determination of financial policies for the business
- Director Authorization of Payment of Bills and Creditors
- Prepare, review, sign or authorized transmission of Payroll Tax Returns
- Knowledge that taxes have not been paid
- Authorization for payroll
- Authorization for making Federal Tax Deposits
- Authorization of Assignment of Electronic Banking, passwords, etc.
- Whether the business uses the electronic Federal tax payment system
- Whether other financial obligations of the business went unpaid
- Whether all or a portion of payroll was met
- Actions Taken to attempt to pay Taxes in whole or in part
- Discussions with Shareholders, officers or other interested parties Regarding nonpayment
- Determining Who handles IRS contacts
- Ascertainment of 3rd party Payer Arrangements and how funds were handled

C. Opportunity to Challenge Tax Liability

- 1. A Taxpayer has and must be afforded an opportunity to challenge the IRS's notice for assessment of the trust fund recovery penalty.

Example

- **Barnhill v. Comm., 155 TC 1**. Mr. Barnhill was a director of a company that failed to pay over employment taxes for its employees between 2010-2012. In 2016, Barnhill received Letter 1153, Trust Fund Recovery Letter, that proposed to assess TFRPs against him as a "responsible person." Barnhill timely filed a protest with the Office of Appeals ("Appeals") disputing the proposed assessment of the TFRPs. In response, Appeals allegedly sent to Barnhill, via regular mail, a Letter 5157, Non-docketed Acknowledgement & Conference, acknowledging his appeal and scheduling a conference to discuss it.

Example

- When Barnhill did not show up to the scheduled conference, the Appeals officer (“AO1”) did not phone Barnhill or otherwise follow up on the reason for his absence. Two days after the scheduled conference date, AO1 sent Barnhill Letter 1536, Closing Letter for Unagreed Employment Tax and Trust Fund Recovery Penalty Cases, which stated that Appeals was returning his case to Collections for assessment of the TFRPs. According to Barnhill, he did not participate in the conference because he did not receive the Letter 5157 sent to him by AO1. The IRS then assessed the TFRPs against Barnhill and sent a notice and demand for payment. When Barnhill didn’t pay, the IRS filed a Notice of Federal Tax Lien (“NFTL”). After receiving the NFTL, Barnhill timely requested a CDP hearing.

Example

- At the CDP hearing, Barnhill attempted to dispute his liability for the TFRPs, claiming he didn’t actually receive Letter 5157 and, therefore, had not been able to participate meaningfully in the Appeals conference about his TFRP liability.AO2 rejected Barnhill's attempt to dispute his underlying TFRP liability after determining that his receipt of Letter 1153 provided Barnhill with a prior opportunity to challenge that liability, even if he didn’t actually receive the Letter 5157 scheduling his Appeals conference. AO2 then issued a determination sustaining the NFTL, which determination Barnhill appealed to the Tax Court. The IRS asked the Court to reject Barnhill's appeal. IRS said that Barnhill’s receipt of Letter 1153 afforded him a “prior opportunity” to challenge his liability for the TFRPs and, consequently, he could not challenge that liability in his CDP hearing. The Tax Court rejected the IRS's contention that Barnhill's receipt of Letter 1153 afforded him a "prior opportunity" to challenge the TFRPs because Barnhill timely filed an appeal of the assessment. The Court determined that if Barnhill didn’t receive the Letter 5157 scheduling his appeals conference for the TFRPs, then his appeal was truncated and incomplete and, therefore, it did not constitute a prior opportunity to dispute his TFRP liability.

V. Proposed Regulation Addresses Interest Recapture on Excess Covid – 19 Credits – REG –. 109032 – 23

A. Overview

- 1. The service has issued proposed regulations that will allow the IRS to assess and collect as underpayment of employment taxes any overpayment interest paid to a taxpayer on an erroneous refund of Covid – 19 credits.
- 2. The proposed regulations apply to the paid sick leave credit and the paid family leave credit under the Families First Coronavirus Response Act, P.L. 116-127, and the American Rescue Plan Act (ARPA) of 2021, P.L. 117-2, and the employee retention credit (ERC) under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, and ARPA.
- 3. The regulation would apply to for-profit businesses, tax-exempt organizations, and certain governmental entities that claim those credits.
- 4. Under the proposed regulations, any overpayment interest paid under Sec. 6611 to an employer for an erroneous refund of the COVID-19 credits would be treated as an underpayment of employment taxes paid under Sec. 3111(a), Sec. 3111(b), or Sec. 3221(a),

SECTION XVII:

TAX EXEMPT ORGANIZATIONS

I. IRS Revises Form 8940, Request for Miscellaneous Determination, to Allow Electronic Filing

I. IRS Revises Form 8940, Request for Miscellaneous Determination, to Allow Electronic Filing

- 1. As part of ongoing efforts to improve service for the tax-exempt community, the Internal Revenue Service issued the revised Form 8940, Request for Miscellaneous Determination, and its instructions to allow electronic filing.

II. Update to Submitting Form 990-N (e-Postcard)

C. Opportunity to Challenge Tax Liability

- 1. The IRS now offers two sign-in options to submit a Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or Form 990-EZ. Both Login.gov and ID.me provide additional security for tax-exempt organizations by adding multi-factor authentication to the sign-in process. When establishing either a Login.gov or ID.me account, previous 990-N filings can be accessed using the same email address associated with your legacy IRS username.

III. Tax Exempt Organization and State Forfeiture

III. Tax Exempt Organization and State Forfeiture

- 1. Generally, the courts hold that when a state nonprofit entity has its corporate powers, rights and privileges suspended by state law they lack the capacity to challenge an IRS revocation of their tax exempt status in either the Tax Court or other federal courts due to lack of jurisdiction. (See XC Foundation v. Comm., TC Memo 2023 – 3)

- IV. Electronic Filing Regulations for Tax-Exempt & Government Entities A. Final Regulations – TD 9972

A. Overview

- 1. The Department of the Treasury published final regulations, regarding “Electronic-Filing Requirements for Specified Returns and Other Documents,” implementing the reduced electronic threshold under Section 2301 of the Taxpayer First Act of 2019 (TFA).

- 2. Under the regulations, taxpayers who are required to file at least 10 returns of any type during the calendar year must file electronically. Generally, the regulation applies after 2023. See the regulations for detailed dates of applicability to specific returns.

- 3. The regulations apply to the following forms:

A. Overview

- 5227, Split-Interest Trust Information Return4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the IRC (if filed by other than a private foundation)
- 1120-POL, U.S. Income Tax Return for Certain Political Organizations8955-SSA, Annual Registration Statement Identifying Separated Participants with Deferred Vested Benefits
- 5500-EZ, Annual Return of A One-Participant (Owners/Partners and Their Spouses) Retirement Plan or A Foreign Plan
- 5330, Return of Excise Taxes Related to Employee Benefit Plans
- 8596, Information Return for Federal Contracts
- 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds

A. Overview

- 4. Under Section 6011(e)(2)(B), the regulations take into account the ability of the taxpayer to e-file at reasonable cost. On a year-by-year and form-by-form basis, the IRS may waive the requirement to file electronically in cases of undue hardship.

- 5. In certain circumstances, a filer may be administratively exempt from the requirement to file electronically. The instructions to each form will set forth details on the waiver. In general, the filer should maintain documentation supporting the undue hardship or other applicable reason for not filing electronically.

A. Overview

- 6. Additionally, Section 3101 of the TFA sets forth “mandatory e-filing by exempt organizations,” which is already in effect. This applies to the following forms:
  - 4720 (if filed by a private foundation)
  - 990, Return of Organization Exempt from Income Tax
  - 990-EZ, Short Form Return of Organization Exempt from Income Tax
  - 990-PF, Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation
  - 990-T, Exempt Organization Business Income Tax Return

V. Tax Exempt Organization and State Forfeiture

A. Overview

- 1. Generally, the courts hold that when a state nonprofit entity has its corporate powers, rights and privileges suspended by state law they lack the capacity to challenge an IRS revocation of their tax exempt status in either the Tax Court or other federal courts due to lack of jurisdiction. (See XC Foundation v. Comm., TC Memo 2023 – 3)

SECTION XVIII:

TAX PRACTICE AND PROCEDURES

I. IRS Finalizes Regs Setting Fee for Obtaining, Renewing PTIN

A. General

- 1. On May 14 finalized final regulations setting the user fee for individuals who apply for or renew a Preparer Tax Identification Number (PTIN). These final regulations adopt, without change, the text of interim final and proposed regulations that reduced the user fee to apply for or renew a PTIN from $21 to $11 (plus $8.75 for a third-party contractor). These regulations are effective on June 15, 2024.

II. Collection Due Process Hearings

II. Collection Due Process Hearings

- 1. The Tax Court has indicated that the IRS does not have to require a face to face CDP hearing that such hearings can be imposed in a telephonic or zoom fashion. (See White v. Comm., TC Memo 2024 – 53)

III. Equitable Relief Innocent Spouse Updates

A. Overview

- 1. Section 6015 provides innocent spouse relief when the requesting spouse did not know, or have reason to know, of the understatement when they signed the joint return, and it would be inequitable to hold the requesting spouse liable for the tax resulting from that understatement.

- 2. The Tax Court may also relieve a requesting spouse from liability if, considering all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for any unpaid tax and relief is not otherwise available.

- 3. However, to qualify for innocent spouse relief, a taxpayer must show that they didn’t meaningfully participate in the proceeding that determined the amount of the joint tax liabilities.

Examples

- **Rawat v. Period, TC Comm., Memo 2024 – 56**. The taxpayer was not entitled to claim equitable relief from joint and several liability for the tax years issues. The couple had been legally separated in the tax year but continued to file a joint return for the years after their separation. The deficiency arose primarily from unreported cancellation of debt, disallowed expenses from Schedule C and un-reported long-term capital gains. In addition, the taxpayer along with her husband managed numerous rental properties. The taxpayer failed the economic hardship condition as she had assets from which payments could be made toward the tax liability and still meet basic living expenses. The condition of knowledge or reason to know was also not met with the taxpayer as she owned, controlled and manage the properties making her a participant in the endeavor. The taxpayer failed to provide any evidence to the contrary.

Examples

- **SAC Thomas v. Comm., 162 TC No. 2, Dec. 62,412**. The taxpayer was not entitled to innocent spouse relief because she failed to establish economic hardship. The taxpayer argued that the Tax Court should fine that her annual income was less than 235% of the federal poverty level and that she did not have the assets to pay off the tax liabilities and\meet reasonable living expenses. The documentation provided did not support the claims made by the taxpayer. Being able to maintain 2 homes proves to be a problem to obtain innocent spouse relief where there was sufficient equity to sell at least one to cover the liabilities.

- **Kraszewska v. Comm., TC Memo 2024 – 26**. The Tax Court determined that the former wife had no knowledge of her husband's overstatement deductions where he controlled the finances and she was given no opportunity to review the returns prior to signing. The court gave the former spouse equitable relief with limited income and raising two children although she had prepared the joint return but was only given two of the three W-2s by her husband and had no knowledge that there was a third W-2.

Examples

- **Frutiger V. Comm., 162 TC No. 5, Dec. 62, 432**. The taxpayers claim for innocent spouse relief was rejected due to a lack of jurisdiction because the taxpayer failed to file his petition within the 90 day deadline pursuant to Section 6015 (e) (1) (A). The taxpayer argued the deadline to file a petition was not jurisdictional but should be heard on equitable grounds. The IRS argued that the deadline is jurisdictional because Congress clearly stated that way under the code. The IRS also referenced a Supreme Court decision Boechler, PC v. Comm., 142 SCt 1943. The Tax Court examined the text, content and relevant historical treatment of the provisions and concluded the 90 day filing deadline was jurisdictional based upon clear language.

IV. Offer in Compromise

A. New Offer in Compromise Booklet Released

- 1 The IRS recently released the latest version (April 2024) of the Form 656 – B: Offer in Compromise Booklet.

- 2. IRS Discretion

Example

- **Cloar v. Comm., TC Memo 2024 – 17**. The Tax Court found the IRS had the discretion to reject an offer in compromise of $25 against tax liability of the hundred and $7400 for the taxpayer had no real assets but, if he obtained employment he would have a monthly positive cash flow. The taxpayer wanted the IRS to treat him as permanently unemployed with no monthly earnings. The IRS rejected that position, stating that he had the potential to be employed again with nearly the same income as he had when he worked with the a state's public defenders commission. Considering his education, the taxpayer had potential to be reemployed. The disability was not one that was permanent in nature.

V. Form 1099 – K Update – IR 2024 – 33

A. Revised Definition of the Form

- 1. The Form 1099 – K is an information return used to report payments the taxpayer received during the year from:
  - Credit, debit or stored value cards such as gift cards (payment cards)
  - Payment apps or online marketplaces for goods or services (third party settlement organizations or TPSOs)

B. Threshold Amounts

- 1. For payment cards, there is no threshold amount that has to be met to receive a Form 1099-K due to payments received through a payment card transaction. Therefore, if the taxpayer received $0.01 of payments from a payment card transaction, the taxpayer should receive a Form 1099-K for those payments.

- 2. The federal reporting threshold for TPSOs for calendar year 2023 remains the same as previous years, which is for total gross payments for goods or services that exceed $20,000 and for which there are more than 200 transactions for a payee.

- 3. The term “payment card” includes credit cards, debit cards, and stored-value cards (including gift cards), as well as payment through any distinctive marks of a payment card (such as a credit card number).

B. Threshold Amounts

- 4. A payment card is issued according to an agreement that provides all of the following: one or more issuers of the cards; a network of persons unrelated to each other, and to the issuer, who agree to accept the cards as payment; and standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept the cards as payment.

- 5. A TPSO is the central organization that has the contractual obligation to make payments to participating payees (generally, a merchant or business) of third party network transactions. An example could include apps used to handle the money transfer between buyers and sellers.

B. Threshold Amounts

- 6. The gross payment amount (Box 1a) on Form 1099-K reports the total, or gross, dollar amount of reportable payment transactions. It doesn't include adjustments for fees, credits, refunds, shipping, cash equivalents or discounts. Those items are not income. Taxpayers can deduct those items from the gross amount when including the income on their tax return. The gross payment amount also does not account for the original purchase price, or basis, of any items sold and whether the items were sold at a gain or loss.

- 7. In Notice 2023 – 74, for the IRS previously delayed the new $600 hoarding threshold requirement for calendar year 2023 retaining the old $20,000 threshold and more than 200 transactions. It appears that the IRS will phase in the threshold starting in 2024 with a $5000 threshold.

VI. Other Matters

A. IRS Announces Extension of Free File Program – IR 2024 – 145.

- 1. The service has announced extension of the current Free file program through 2029 after an agreement that will continue to make the free private sector tax software available to taxpayers.

B. IRS to In Automatic Bounties for Late Filing of Foreign Gifts and Bequests Forms

- 1. The IRS will no longer automatically assess penalties at the time of filing for a late-filed Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gift.

- 2. By the end of 2024, the IRS will begin reviewing any reasonable-cause statements taxpayers attach to late-filed Forms 3520 and Forms 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, for the trust portion of the form before assessing any penalty.

C. Deficiency Notice and Burden of Proof

- 1. IRS Deficiency Notice was sent in error which was material in nature and invalidated IRS deficiency notice which taxpayer had not received until several years after IRS mailed same notice to address it which taxpayer claimed to have never lived. The IRS compared USPS National Change of Address Database with the taxpayer's name and old address IRS had received change of address form but did not process it properly. (See Phillips v. Comm., 2024 – 44)

SECTION XIX:

TEXAS TAX UPDATE

I. Franchise Tax

A. Increased to the tax Due Threshold and Removal of Filing Requirements

- 1. Effective for reports originally due on or after Jan. 1, 2024, Senate Bill (SB) 3, 88th Legislature, Second Called Session, increases the no tax due threshold to $2.47 million and prohibits the Comptroller's office from requiring taxable entities whose annualized total revenue is less than or equal to the no tax due threshold to file a No Tax Due Report.

- 2. The bill also repealed the requirement that a new veteran-owned business file a No Tax Due Report during its initial five-year period. Read on to learn how we are implementing these changes.

B. No Tax Due Report – Form 05 – 163

- 1. Since taxable entities whose annualized total revenue is less than or equal to the no tax due threshold and qualifying new veteran-owned businesses are no longer required to file a No Tax Due Report, the Comptroller is discontinuing the tax Did Report for the 2024 port year and beyond.

- 2. The form will not be available for any new reporting periods.

- 3. The following are the five types of entities that could file a No Tax Due Report prior to 2024, and how each entity will now report (beginning with the 2024 report):

A. Overview

- **Taxable entities whose annualized total revenue was less than or equal to the no tax due threshold** do not owe any tax and are not required to file a franchise tax report. They are, however, still required to file a Public Information Report (PIR) or Ownership Information Report (OIR);

- **Qualifying new veteran-owned businesses** are not required to file a franchise tax report for the initial five-year period that they qualify as a new veteran-owned business. For new veteran-owned businesses, no PIR or OIR is required during this initial five-year period;

- **Entities that qualify as passive entities** must file either the long form or the EZ Computation form. Both forms are updated with a circle to darken, which is in the taxpayer information section at the top of the form. Other than signing the report, passive entities need not provide information in any other section of the report and no PIR or OIR is required;

- **Qualifying real estate investment trusts (REITs)** also must file either a long form or EZ Computation form and darken the appropriate circle in the taxpayer information section at the top of the form. Other than signing the report, REITs need not provide information in any other section of the report. REITs must continue to file a PIR or OIR; and

- **Taxable entities with zero Texas gross receipts** must file either a long form or EZ Computation form and complete specific line items on the form to compute the entity's total revenue and report zero on the Texas gross receipts line. Entities with zero Texas gross receipts must continue to file a PIR or OIR.

C. Opportunity to Challenge Tax Liability

- 4. For reports originally due on or after Jan. 1, 2024, a qualifying new veteran-owned business is no longer required to file a No Tax Due Report during its initial five-year period.

- 5. The long form, EZ Computation form, PIR, OIR and instructions for each tax year are available.

C. Combined Groups

- 1. A combined group must include all taxable entities in the combined group report even if any member, on a separate entity basis, has annualized total revenue less than or equal to the no tax due threshold.

- 2. If a combined group's annualized total revenue is less than or equal to the no tax due threshold, the combined group is not required to file a franchise tax report, an Affiliate Schedule (Form 05-166), or a Common Owner Information Report (Form 05-177) for that report year. Each individual member of the combined group that is organized in Texas or has nexus in Texas must file a PIR or OIR.

D. Benefits Allowed for the Compensation Deduction

- **1. 202310005L**. Tax Policy Division issued a memo to Audit Division regarding benefits allowed for the compensation subtraction. The issue in determining the amount of compensation deduct whether certain benefits are includable in the compensation amount. The tax policy division determine that for the cost of an item to be included in benefits for the compensation deduction the item must be similar to those listed in Tax Code Section 171.1013 (b) 2) and that the item provides value to the employee in their personal capacity, the deductible for federal tax purposes, and not already included in wages and compensation

II. Sales and Use Tax Updates

A. Residual Fees for Promoting Credit Card Processor Services – Star No. 202407021L

- The taxpayer provides a variety of technology-based services to clients in the retail and hospitality business, including the sale and installation of point-of-sale systems. The taxpayer collects sales and use tax on the sale of the point-of-sale systems. The taxpayer also enters into a referral agreement with a credit card processor to promote the processor's services to the taxpayer's clients that accept credit cards as payment for goods and services. The taxpayer receives a residual fee from the credit card processor for each accepted merchant whose merchant's agreement was submitted by the taxpayer. The residual fee is a percentage of the processor's income from fees charged to merchants after subtracting the processor's costs. The Comptroller's office determined that the taxpayer's service is not taxable. The residual fee compensates the taxpayer for promoting the processor's services and submitting executed merchant agreements. These activities do not fall under the services listed as taxable services under Tax Code Section 151.0101 (Taxable Services). Therefore, the taxpayer's services are not subject to sales and use tax.

B. Credit Card Processing Fees –Star No. 202406004M

- The Tax Policy Division issued a memo to the Audit Division related to the taxability of credit card processing fees.

- Retailers that separately state credit card processing fees to their customers have claimed that the fees are not part of the sales price of taxable items sold because the fees are excluded from either:
  - The sales price of taxable items as finance, carrying and service charges, or interest from extending credit to the purchaser: or
  - The definition of data processing services as the settling of an electronic payment transaction.

- The sales price of a taxable item means the total amount for which a taxable item is sold, without a deduction for the cost of materials used, labor or services employed, and other expenses. Finance, carrying and service charges, or interest from credit extended for sales of taxable items are excluded from the sales price.

B. Credit Card Processing Fees –Star No. 202406004M

- A retailer who separately states credit card processing fees to its customers is not extending credit to the customers for the purchase of a taxable item. Instead, the retailer is merely accepting credit cards as a means of payment. Accordingly, the credit card processing fee is not a finance, carrying and service, or interest charge from extending credit; and is not excluded from the sales price of taxable items.

- The settling of an electronic payment transaction by certain payment processors and financial institutions is excluded from the definition of data processing and is not taxable. However, a retailer selling taxable items is not acting in the capacity of a credit card payment processor or financial institution and its sales do not fall under this exclusion. Credit card processing fees are an expense incurred by a retailer in connection with the sale of taxable items. When a retailer separately states a charge to its customers to recover that expense, the separately stated charge is part of the sales price of the retailer's taxable items.

C. Membership Base Consulting Services – Star No. 202407027L

- The taxpayer charges members an initial membership fee and a monthly fee. As part of its services, the taxpayer assigns each member a client success manager who meets with the member's leadership team to work on coaching and mentoring. Members have access to a member network that includes access to live expos and conferences. Taxpayer also offers members access to an online hub that provides various business resources. The hub includes training materials, such as educational and motivational videos, that are available for download or online viewing. It also contains standardized documents such as bid sheets and budget templates. The Tax Policy Division determined that the taxpayer's membership fees are a lump-sum charge for nontaxable consulting services and taxable data processing and information services. The entire membership fee is presumed subject to Texas sales and use tax. The 20 percent exemption for data processing and information services applies to the taxpayer's membership fees.

D. Exclusion from Total Revenue for Subcontracting Payments – Star No. 202407025L

- The taxpayer provides on-site consulting and supervision services on completions and workovers of oil and gas drilling and workover rigs. The taxpayer uses contract field operation consultants (subcontractors) to perform the majority of the work.

- A payment to a third party qualifies for the revenue exclusion in Section 171.1011(g)(3) where:

D. Exclusion from Total Revenue for Subcontracting Payments – Star No. 202407025L

- The payment is a subcontracting payment, meaning the payments the taxpayer makes to another entity to do work or provide materials that the taxpayer is in turn obligated to provide its customer and for which that customer is compensating the taxpayer;
- The payment is a flow-through fund, meaning that the taxpayer's customer is compensating the taxpayer for the subcontractor's work;
- The payment is mandated by contract or subcontract, meaning that the taxpayer has a contractual obligation (in the contract or subcontract) to pay its subcontractor; and
- The payment is in connection with the actual or proposed design, construction, remodeling, remediation, or repair of improvements to real property, which requires more than a tangential or incidental relationship between these activities and the services, labor, or materials for which the subcontractors receive payment. However, it does not require that the activity of the taxpayer's subcontractor affect a material or physical change to the property.

D. Exclusion from Total Revenue for Subcontracting Payments – Star No. 202407025L

- The Comptroller's office concluded that the taxpayer's subcontracting payments were subcontracting payments for services or labor in connection with the actual or proposed design, construction, remodeling, remediation, or repair of improvements on real property and could be excluded from total revenue under Section 171.1011(g)(3).