2024-25 BUSINESS TAX UPDATE

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Blaise has conducted over 1,100 seminars and workshops throughout Texas and the United States and has numerous publications in tax and accounting. His seminars include an Annual Federal Tax Updates, Individual Tax Updates. Business Tax Updates, Merger and Acquisitions, Cryptocurrency Issues, Hobby Loss Issues, Real Estate Taxation, Pass-Throughs including Partnerships and S Corporations, Investment Diversification. Agricultural Tax Matters and Succession Planning to name a few. He also has numerous publications on tax matters, succession planning and governance. He has received numerous awards for his service in education and continuing education including the TXCPA Recognition for Meritorious Service to the Public Accounting and the Fellow Award in 2019 from the San Antonio Chapter of CPAs.

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SECTION I :

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."*

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. 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. Comm., 70 TC 715 (1978) affd. 615 F. 2d 578 (2nd Cir, 1980))

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)).

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.

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.

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.

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.

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.

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. 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.

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.

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.

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. 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. 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.

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.

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.

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.

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.

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. 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.

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.*

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.

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.

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.

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.

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.
-

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.

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.

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

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. However, net operating losses on Schedule 1 are disregarded in the computation.

5. Wages and unemployment compensation 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.

7. The excess business loss limitation continues until the end of 2028.

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.

B. Farm Product Sales

1.Amounts received from the sales of products raised for sale or bought for resale, such as livestock, produce, or grains, are reported on Schedule F. This includes money and the fair market value of any property or services you receive.

2. When you sell farm products bought for resale, the profit or loss is the difference between your selling price (money plus the fair market value of any property) and your basis in the item (usually the cost).

Example

In 2022, Farmer bought 20 feeder calves for $27,000 for resale. He sold them in 2021 for $35,000. He reports the $35,000 sales price on Schedule F, line 1a, subtracts the $27,000 as basis on line 1b, with a resulting $8,000 profit on line 1c.

3. Sales of livestock held for draft, breeding, sport, or dairy purposes may result in ordinary or capital gains or losses, depending on the circumstances. These sales are reported on Form 4797.

4. Animals that you don't hold primarily for sale are considered business assets of your farm.

C. Livestock

1. Gain or loss from the sale or exchange of this livestock may qualify as a Section 1231 gain or loss. However, any part of the gain that is ordinary income from the recapture of depreciation is not included as section 1231 gain.

2. The sale or exchange of livestock used in a farm business qualifies as a Aection 1231 transaction if the taxpayer held the livestock for 12 months or more (24 months or more for horses and cattle).

3. For Section 1231 transactions, livestock includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. Also, for Section 1231 transactions, livestock does not include chickens, turkeys, pigeons, geese, emus, ostriches, rheas, or other birds, fish, frogs, reptiles, etc.

4. If livestock is held primarily for draft, breeding, dairy, or sporting purposes, it is used in the farm business. The purpose for which an animal is held ordinarily is determined by a farmer's actual use of the animal.

5. An animal is not held for draft, breeding, dairy, or sporting purposes merely because it is suitable for that purpose, or because it is held for sale to other persons for use by them for that purpose.
6. A draft, breeding, or sporting purpose may be present if an animal is disposed of within a reasonable time after it is prevented from its intended use or made undesirable as a result of an accident, disease, drought, or unfitness of the animal.

Examples

Taxpayer discovers an animal that was intended to be use for breeding purposes is sterile. The taxpayer disposes of the animal within a reasonable time. This animal was held for breeding purposes.

Taxpayer sells the entire herd, including young animals that would have used for breeding or dairy purposes had the taxpayer remained in business. These young animals were held for breeding or dairy purposes. Also, if the taxpayer sells young animals to reduce your breeding or dairy herd because of drought, these animals are treated as having been held for breeding or dairy purposes.

The taxpayer is in the business of raising registered cattle for sale to others for use as breeding cattle. The business practice is to breed the cattle before sale to establish their fitness as registered breeding cattle. The taxpayer's use of the young cattle for breeding purposes is ordinary and necessary for selling them as registered breeding cattle. Such use does not demonstrate that the taxpayer is holding the cattle for breeding purposes. However, those cattle held as additions or replacements to breeding herd to produce calves are considered to be held for breeding purposes, even though they may not actually have produced calves.

7. Farmers or ranchers who use the cash method of accounting figure their gain or loss on the sale of livestock used in their farming business as follows.

a. Gain on the sale of raised livestock is generally the gross sales price reduced by any expenses of the sale. Expenses of sale include sales commissions, freight or hauling from farm to commission company, and other similar expenses. The basis of the animal sold is zero if the costs of raising it were deducted during the years the animal was being raised. The gross sales price minus your adjusted basis and any expenses of sale is the gain or loss.

Example

A farmer sold a breeding cow on January 8, 2024, for $1,250. Expenses of the sale were $125. The cow was bought July 2, 2016, for $1,300. Depreciation (not less than the amount allowable) was $867.

Gross sales price		$1,250
Cost (basis)	$1,300	
Minus: Depreciation deduction	867	
Unrecovered cost (adjusted basis)	$ 433	
Expense of sale	125	558
Gain realized		**$ 692**

8. If the taxpayer sells or exchanges more livestock, including poultry, than the taxpayer normally would in a year because of a drought, flood, or other weather-related condition, the taxpayer may be able to postpone reporting the gain from the additional animals until the next year. The taxpayer must meet all the following conditions to qualify.

- Your principal trade or business is farming.
- You use the cash method of accounting.
- You can show that, under your usual business practices, you wouldn't have sold or exchanged the additional animals this year except for the weather-related condition.
- The weather-related condition caused an area to be designated as eligible for assistance by the federal government.

9. The taxpayer must figure the amount to be postponed separately for each generic class of animals—for example, hogs, sheep, and cattle.

10. The steps to figure the amount of gain to be postponed for each class of animals are as follows:

- Divide the total income realized from the sale of all livestock in the class during the tax year by the total number of such livestock sold. For this purpose, don't treat any postponed gain from the previous year as income received from the sale of livestock.
- Multiply the result in (1) by the excess number of such livestock sold solely because of weather-related conditions.

Example

A calendar year taxpayer normally weans 100 beef calves in the fall and feed them through the winter, selling in January. As a result of a drought, the taxpayer decided he did not have enough feed for all of the calves, so he sold 35 head in addition to the 100 calves sold in January. As a result, he sold 135 head and realized $175,500 from the sale ($175,500 ÷ 135 = $1,300 per head). The affected area was declared a disaster area eligible for federal assistance. The income postponed until 2024 is $45,500 [($175,500 ÷ 135) × 35].

11. To postpone gain, attach a statement to the tax return for the year of the sale. The statement must include the taxpayer's name and address and give the following information for each class of livestock for which you're postponing gain.

- A statement that the gain is being postponed under section 451(e).
- Evidence of the weather-related conditions that forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the federal government because of weather-related conditions.
- A statement explaining the relationship of the area affected by the weather-related condition to the early sale or exchange of the livestock.
- The number of animals sold in each of the 3 preceding years.
- The number of animals that would have sold in the tax year had the taxpayer followed normal business practice in the absence of weather-related conditions.
- The total number of animals sold and the number sold because of weather-related conditions during the tax year.

D. Pasture Income and Rental

1. It is treated as "Other Income" on Schedule F. However, if the taxpayer is simply renting the pasture or other farm real estate for a flat cash amount without providing services, report the income as rent on Schedule E.

E. Crop Shares

1. Is generally treated as rental income. If the taxpayer receives e rent in the form of crop shares or livestock, the rental income is included in self-employment income if:

- The arrangement with the tenant provides that the tenant will materially participate in the production or management of production of the farm products on the land, and
- The taxpayer materially participates.

2. If there is a lack of material participation the income is reported on Form 4835 and the net income or loss carries over to Schedule E and is not subject to self-employment tax.

3. Crop shares that a taxpayer receives as a landlord and feed to the taxpayer' s livestock are considered converted to money when fed to the livestock. It must include the fair market value of the crop shares in income at that time.

4. Crop shares that a taxpayer receives as a landlord and give to others are considered converted to money when you make the gift. The taxpayer must report the fair market value of the crop share as income, even though someone else receives payment for the crop share. This applies even if the gift is made to a qualified charitable organization.

Example

A tenant farmed part of the taxpayer' s land under a crop-share arrangement. The tenant harvested and delivered the crop in the taxpayer's name to an elevator company. Before selling any of the crop, the taxpayer instructed the elevator company to cancel the taxpayers warehouse receipt and make out new warehouse receipts in equal amounts of the crop in the names of the taxpayer' s children. They sell their crop shares in the following year and the elevator company makes payments directly to the taxpayer' s children. The taxpayer is considered to have received rental income and then made a gift of that income. The taxpayer must include the fair market value of the crop shares in your income for the tax year taxpayer gave the crop shares to the taxpayer's children.

5. The taxpayer is involved in a rental or crop-share lease arrangement, any loss from these activities may be subject to the limits under the passive loss rules.

F. Commodity Credit Corporation (CCC) Loans

1. As a general rule, a taxpayer does not report loans received as income. However, if in receipt of the loan the taxpayer pledges part or all of agricultural production to secure a CCC loan, the taxpayer can treat the loan as if it were a sale of the crop and report the loan proceeds as income in the year you receive them.

2. This is not an accounting method that requires IRS approval.

3. Once the taxpayer reports a CCC loan as income for the year received, the taxpayer must generally report all CCC loans in that year and later years in the same way. Now if the taxpayer wishes to change the method of reporting then the client would file Form 3115 pursuant to Revenue Procedure 2008 – 52 as an automatic consent to change the method of accounting for loans received from the CCC.

4. To elect to report a CCC loan as income, include the loan proceeds as income on Schedule F for the year received and attach a statement to your return showing the details of the loan. The statement must file the statement and the return by the due date of the return, including extensions. If election is not made on a timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the return. File the amended return at the same address you filed the original return.

5. When you make this election, the amount you report as income becomes your basis in the commodity. If the taxpayer later repays the loan, redeem the pledged commodity, and sell it, the taxpayer then reports as income at the time of sale the sale proceeds minus your basis in the commodity

6. If a taxpayer forfeits the pledged crops to the CCC in full payment of the loan, the forfeiture is treated for tax purposes as a sale of the crops. Often, a Form 1099-Aa is issued on a forfeiture.

7. Under the CCC nonrecourse marketing assistance loan program, the repayment amount for a loan secured by the taxpayer' s pledge of an eligible commodity is generally based on the lower of the loan rate or the prevailing world market price for the commodity on the date of repayment.
8. If the taxpayer repays the loan when the world price is lower, the difference between that repayment amount and the original loan amount is market gain. The taxpayer generally will receive a Form 1099-G showing the market gain you realized. Market gain should be reported as follows.

- If the taxpayer elected to include the CCC loan in income in the year of receipt the taxpayer will not include the market gain in income. However, the taxpayer does adjust the basis of the commodity for the amount of the market gain.
- If the taxpayer does include the CCC loan in income in the year received, include the market gain in your income.

G. Conservation Reserve Program (CRP)

1. Under the CRP, if a taxpayer owns or operate highly erodible or other specified cropland, the taxpayer may enter into a long-term contract with the USDA, agreeing to convert to a less intensive use of that cropland.

2. The taxpayer must include the annual rental payments and any one-time incentive payment you receive under the program on the appropriate lines of Schedule F

H. Crop Insurance and Crop Disaster Payments

1. The taxpayer must include in income any crop insurance proceeds you receive as the result of physical crop damage or reduction of crop revenue, or both. It is generally included in the year of receipt.

2. Treat as crop insurance proceeds the crop disaster payments you receive from the federal government as the result of destruction or damage to crops, or the inability to plant crops, because of drought, flood, or any other natural disaster.

3. A taxpayer can postpone reporting some or all crop insurance proceeds as income until the year following the year the physical damage occurred if the taxpayer meets all the following conditions.

- Uses the cash method of accounting.
- Receives the crop insurance proceeds in the same tax year the crops are damaged.
- Able to show that under your normal business practice you would have included income from the damaged crops in any tax year following the year the damage occurred.

4. The deferral is not allowed for proceeds received from revenue insurance policies.

5. To postpone reporting some or all crop insurance proceeds received in 2023, report the amount received on Schedule F, line 6a, but don't include it as a taxable amount on line 6b. Check the box on line 6c and attach a statement to your tax return. The statement must include the taxpayer' s name and address and contain the following information.

- A statement that the election is being made under section 451(d) and Regulations section 1.451-6.

- The specific crop or crops physically destroyed or damaged.
- A statement that under normal business practice you would have included income from some or all of the destroyed or damaged crops in gross income for a tax year following the year the crops were destroyed or damaged.
- The cause of the physical destruction or damage and the date or dates it occurred.
- The total payments you received from insurance carriers, itemized for each specific crop, and the date you received each payment.
- The name of each insurance carrier from whom you received payments.

6. One election covers all crops representing a single trade or business. However, if the taxpayer has more than one farming business, a separate election will be made for each one. By way of illustration, a taxpayer operates 2 separate farms on which different crops are grown and sold and there are separate books and records for each farm.

7. An election is binding for the year unless the IRS approves your request to change it.

I. Feed Assistance and Payments

1. The Disaster Assistance Act of 1988 authorizes programs to provide feed assistance, reimbursement payments, and other benefits to qualifying livestock producers if the Secretary of Agriculture determines that, because of a natural disaster, a livestock emergency exists. These programs include partial reimbursement for the cost of purchased feed and for certain transportation expenses. They also include the donation or sale at a below-market price of feed owned by the CCC.

2. What is included in income is the following:

- The market value of donated feed received,
- The difference between the market value and the price you paid for feed you buy at below-market prices, and
- Any cost reimbursement you receive.

3. The items listed above are included in income in the year of receipt. These are viewed as agricultural program payments.

4. The taxpayer generally can take a current deduction for the same amount as a feed expense.

J. Income From Cooperatives

1. If a taxpayer purchases farm supplies through a cooperative, you may receive income from the cooperative in the form of patronage dividends (refunds). Likewise, if the taxpayer sells farm products through a cooperative, they may receive either patronage dividends.

2. The cooperative will report the income on Form 1099-PATR or a similar form and send a copy to the IRS. Form 1099-PATR may also show an alternative minimum tax adjustment that must be included on Form 6251.

3. The patronage dividends is reported as income on Schedule F for the tax year received. This includes the following items.

- Money paid as a patronage dividend, including cash advances received (for example, from a marketing cooperative).
- The stated dollar value of qualified written notices of allocation.
- The fair market value of other property.

4. If the taxpayer receives a qualified written notice of allocation as part of a patronage dividend, the taxpayer must generally include its stated dollar value in your income on Schedule F in the year you receive it. A written notice of allocation is qualified if at least 20% of the patronage dividend is paid in money or by qualified check and either of the following conditions is met.

- The notice must be redeemable in cash for at least 90 days after it's issued, and the taxpayer must have received a written notice of your right of redemption at the same time as the written notice of allocation.
- The taxpayer must have agreed to include the stated dollar value in income in the year you receive the notice by doing one of the following.

    a. Signing and giving a written agreement to the cooperative.
    b. Getting or keeping membership in the cooperative after it adopted a bylaw providing that membership constitutes agreement. The cooperative must notify you in writing of this bylaw and give you a copy.
    c. Endorsing and cashing a qualified check paid as part of the same patronage dividend. You must cash the check by the 90th day after the close of the payment period for the cooperative's tax year for which the patronage dividend was paid.

5. In addition, the taxpayer can deduct on Schedule F, Part II, any loss incurred on the redemption of a qualified written notice of allocation you received in the ordinary course of your farming business. The loss is the difference between the stated dollar amount of the qualified written notice the taxpayer included in income and the amount you received when the taxpayer redeemed it.

6. A taxpayer should not include in income patronage dividends from buying capital assets or depreciable property used in in the farm business. Rather, the taxpayer reduces the basis of these assets by the dividends. This reduction is taken into account as of the first day of the tax year in which the dividends are received. If the dividends are more than the taxpayer’s unrecovered basis, reduce the unrecovered basis to zero and include the difference on Schedule F for the tax year you receive them.

7. This also applies to amounts received from the sale, redemption, or other disposition of a nonqualified notice of allocation that resulted from buying or selling capital assets or depreciable property.

8. If the dividends are for buying or selling capital assets or depreciable property that the taxpayer did not own at any time during the year received the dividends, the taxpayer must include them on Schedule F, unless one of the following rules applies.

- If the dividends relate to a capital asset you held for more than 1 year for which a loss was or would have been deductible, treat them as gain from the sale or exchange of a capital asset held for more than 1 year.
- If the dividends relate to a capital asset for which a loss wasn't or wouldn't have been deductible, don't report them as income (ordinary or capital gain).

9. If the dividends are for selling capital assets or depreciable property during the year received the dividends, treat them as an additional amount received on the sale.

K. Section 1231 Transactions

1. Gain or loss on the following transactions is subject to section 1231 treatment.

- ***Sale or exchange of cattle and horses.*** The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 24 months or longer.
- ***Sale or exchange of other livestock.*** This livestock must be held for draft, breeding, dairy, or sporting purposes and held for 12 months or longer. Other livestock include hogs, mules, sheep, goats, donkeys, and other fur-bearing animals. Other livestock does not include poultry.
- ***Sale or exchange of depreciable real property or personal property.*** This property must be used in your business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. This property must also be either real property or is of a kind that is subject to depreciation under section 167 of the Internal Revenue Code. Examples of depreciable personal property include farm machinery and trucks. It also includes amortizable section 197 intangibles.
- ***Sale or exchange of real estate.*** This property must be used in your business and held longer than 1 year. Examples are your farm or ranch (including barns and sheds).
- ***Sale or exchange of unharvested crops.*** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person, and the land must have been held longer than 1 year. You cannot keep any right or option to reacquire the land directly or indirectly (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a leasehold on the land, even if sold to the same person in a single transaction, are not considered a section 1231 transaction.
- ***Distributive share of partnership gains and losses.*** Your distributive share must be from the sale or exchange of property listed above and held by the partnership for longer than 1 year (or for the required period for certain livestock). You will receive Schedule K-1 (Form 1065) showing the appropriate classification of any gains or losses distributed to you.
- ***Condemnation.*** The condemned property (defined in chapter 11) must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.
- ***Casualty or theft.*** The casualty or theft must have affected business property, property held for the production of rents or royalties, or investment property (such as notes and bonds). You must have held the property longer than the required holding period. However, if your casualty or theft losses are more than your casualty or theft gains, the net casualty or theft loss is fully deductible and is not combined with other section 1231 transactions in the section 1231 computation. Section 1231 does not apply to personal casualty gains and losses.

2. Property held for sale to customers.. A sale, exchange, or involuntary conversion of property held mainly for sale to customers is not a section 1231 transaction. If the taxpayer will get back all or close to all of their investment in the property If you have a net section 1231 gain, it is ordinary income up to your nonrecaptured section 1231 losses from previous years, explained next. The rest, if any, is long-term capital gain.

3. Section 1252 property. If the taxpayer disposes of farmland you held more than 1 year and less than 10 years at a gain and the taxpayer was allowed deductions for soil and water conservation expenses for the land, the taxpayer must treat part of the gain as ordinary income and treat the balance as section 1231 gain.

a. The following types of gains are not subject to Section 1252:

- Disposition of farmland by gift.
- Transfer of farm property at death (except for income in respect of a decedent).

b. The amount reported as ordinary income is the lesser of the following amounts.

- The gain (determined by subtracting the adjusted basis from the amount realized from a sale, exchange, or involuntary conversion, or the FMV for all other dispositions).
- The total deductions allowed for soil and water conservation expenses multiplied by the applicable percentage.

c. The applicable percentage used in the computation is based on the length of time the taxpayer held the land.

d. If you dispose of your farmland within 5 years after the date you acquired it, the percentage is 100%.

e. If you dispose of the land within the 6th through 9th year after you acquired it, the applicable percentage is reduced by 20% a year for each year or part of a year you hold the land after the 5th year.

f. If you dispose of the land 10 or more years after you acquired it, the percentage is 0%, and the entire gain is a section 1231 gain.

4. Section 1255 property. If the taxpayer receives certain cost-sharing payments on property and the payments are excluded from income, the taxpayer may have to treat part of any gain as ordinary income and treat the balance as a section 1231 gain. However, if the taxpayer chooses not to exclude these payments, the taxpayer will not have to recognize ordinary income under this provision.

a. The taxpayer reports as ordinary income the lesser of the following: .

- The applicable percentage of the total excluded cost-sharing payments.
- The gain on the disposition of the property.

b. he taxpayer does not report ordinary income under this rule to the extent the gain is recognized as ordinary income under sections 1231 through 1254, 1256, and 1257.

c. The applicable percentage of the excluded cost-sharing payments to be reported as ordinary income is based on the length of time you hold the property after receiving the payments.

d. If the property is held less than 10 years after you receive the payments, the percentage is 100%.

e. After 10 years, the percentage is reduced by 10% a year, or part of a year, until the rate is 0%.

f. Use Form 4797, Part III, to figure the ordinary income part of a gain from the sale, exchange, or involuntary conversion of section 1252 property and section 1255 property.

L. Diseased Livestock

1. If the taxpayer's livestock dies from disease, or are destroyed, sold, or exchange should ed because of disease, even though the disease isn't of epidemic proportions, treat these occurrences as involuntary conversions.

2. If the taxpayer chooses to postpone reporting gain on the disposition of diseased livestock, you must attach a statement to your return explaining that the livestock were disposed of because of disease.

3. If the taxpayer sells livestock (other than poultry) held for draft, breeding, or dairy purposes solely because of drought, flood, or other weather-related conditions, treat the sale or exchange as an involuntary conversion.

4. Only livestock sold in excess of the number you normally would sell under usual business practice, in the absence of weather-related conditions, are considered involuntary conversions.

IV. Farm Expenses

A. Prepaid Farm Supplies

1. Prepaid farm supplies include the following items if paid for during the year.

- Feed, seed, fertilizer, and similar farm supplies not used or consumed during the year, but not including farm supplies that you would have consumed during the year if not for a fire, storm, flood, other casualty, disease, or drought.
- Poultry (including egg-laying hens and baby chicks) bought for use (or for both use and resale) in your farm business. However, include only the amount that would be deductible in the following year if you had capitalized the cost and deducted it ratably over the lesser of 12 months or the useful life of the poultry.
- Poultry bought for resale and not resold during the year.

2. If the taxpayer uses the cash method of accounting to report your income and expenses, the deduction for prepaid farm supplies in the year you pay for them may be limited to 50% of the taxpayer's other deductible farm expenses for the year (all Schedule F deductions except prepaid farm supplies).

3. If the limit applies, the taxpayer can deduct the excess cost of farm supplies other than poultry in the year of use or consumption of the supplies. The excess cost of poultry bought for use (or for both use and resale) is deductible in the year following the year by the taxpayer paid for it. The excess cost of poultry bought for resale is deductible in the year you sell or otherwise dispose of that poultry.

Example

During 2022, Bubba bought fertilizer ($40,000), feed ($10,000), and seed ($5,000) for use on your farm in the following year. His total prepaid farm supplies expense for 2022 is $55,000. His other deductible farm expenses totaled $100,000 for 2022. Therefore, your deduction for prepaid farm supplies can't be more than $50,000 (50% of $100,000) for 2022. The excess prepaid farm supplies expense of $5,000 ($55,000 − $50,000) is deductible in a later tax year when he can use or consume the supplies.
4. There are some exceptions to get around the limit on the deduction. Specifically, the limit doesn't apply if the taxpayer is a farm-related taxpayer and either of the following apply.

1. The prepaid farm supplies expense is more than 50% of other deductible farm expenses because of a change in business operations caused by unusual circumstances.
2. The total prepaid farm supplies expense for the preceding 3 tax years is less than 50% of the total other deductible farm expenses for those 3 tax years.

5. A taxpayer is a farm-related taxpayer if any of the following tests apply.

1. The main home is on a farm.
2. The principal business is farming.
3. A member of your family meets either of the above).

B. Prepaid Feed

1. If you report your income and expenses under the cash method of accounting, you cannot deduct in the year paid the cost of feed your livestock will consume in a later year unless you meet all the following tests.

a. The payment is for the purchase of feed rather than a deposit.
b. The prepayment has a business purpose and is not merely for tax avoidance.
c. Deducting the prepayment does not result in a material distortion of your income.

2. If you meet all three tests, you can deduct the prepaid feed, subject to the limit on prepaid farm supplies discussed earlier.

3. If you fail any of these tests, you can deduct the prepaid feed only in the year it is consumed.

4. This does not apply to the purchase of commodity futures contracts.

5. Whether a payment is for the purchase of feed or a deposit depends on the facts and circumstances in each case.

6. It is for the purchase of feed if you can show it was made under a binding commitment to accept delivery of a specific quantity of feed at a fixed price and you are not entitled, by contract or business custom, to a refund or repurchase.

7. The following are some factors that show a payment is a deposit rather than for the purchase of feed.

- The absence of specific quantity terms.
- The right to a refund of any unapplied payment credit at the end of the contract.
- The seller's treatment of the payment as a deposit.
- The right to substitute other goods or products for those specified in the contract.

8. A provision permitting substitution of ingredients to vary the particular feed mix to meet your livestock's current diet requirements will not suggest a deposit.

9 A price adjustment to reflect market value at the date of delivery is not, by itself, proof of a deposit.

10.The prepayment has a business purpose only if you have a reasonable expectation of receiving some business benefit from prepaying the cost of livestock feed. The following are some examples of business benefits.

- Fixing maximum prices and securing an assured feed supply.
- Securing preferential treatment in anticipation of a feed shortage.

- Whether the prepayment was a condition imposed by the seller and whether that condition was meaningful.

11. The following are some factors considered in determining whether deducting prepaid livestock feed materially distorts income.

- Your customary business practice in conducting your livestock operations.
- The expense in relation to past purchases.
- The time of year you made the purchase.
- The expense in relation to your income for the year

C. Breeding Fees

1. Generally, a taxpayer can deduct breeding fees as a farm business expense. However, if the breeder guarantees live offspring as a result of the breeding or other veterinary procedure, the costs must capitalize.

2. If the taxpayer uses the accrual method of accounting, the taxpayer must capitalize the fees and allocate them to the cost basis of the calf, foal, etc.

D. Fertilizer and Lime

1. A taxpayer can deduct in the year paid or incurred the cost of fertilizer, lime, and other materials applied to farmland to enrich, neutralize, or condition it if the benefits last a year or less. These could also be in the prepaid farm supply expenses.

2. If the benefits of the fertilizer, lime, or other materials last substantially more than 1 year, then the taxpayer the generally capitalizes these cost and deduct a part each year the benefits.

3. However, a taxpayer can choose to deduct these expenses in the year paid or incurred. Under this scenario, the taxpayer will need IRS approval if you later decide to capitalize the cost of previously deducted items.

4. If a taxpayer sells farmland on which fertilizer or lime has been applied and if the selling price of the land includes part or all of the cost of the fertilizer or lime, the taxpayer reports the sale amount attributable to the fertilizer or lime as ordinary income.

5. Farmland, for these purposes, is land used for producing crops, fruits, or other agricultural products or for sustaining livestock. It doesn't include land that the taxpayer has never used previously for producing crops or sustaining livestock.

E. Items Purchased for Resale

1. If a taxpayer uses the cash method of accounting, they generally can deduct the cost of livestock and other items purchased for resale only in the year of sale. Likewise, the costs associated with freight charges for transporting the livestock are also deductible.

Example

Bubba uses the cash method of accounting. In 2022, he purchases 50 steers you will sell in 2021. He cannot deduct the cost of the steers on your 2020 tax return. He can deduct the cost on his 2022 Schedule F, Part I.

2. If the former is a cash method farmer, the farmer can deduct the cost of hens and baby chicks bought for commercial egg production, or for raising and resale, as an expense on Schedule F, Part I, in the year paid if you do it consistently and it doesn't distort income.

3. The farmer also can deduct the cost of seeds and young plants bought for further development and cultivation before sale as an expense on Schedule F, Part I, when paid if the farmer does this consistently and the farmer does not figure your income on the crop method.

4. If the farmer deducts the cost of chickens, seeds, and young plants as an expense, the farmer should report their entire selling price as income. The farmer cannot deduct the cost from the selling price.

5. Likewise the farmer cannot deduct the cost of seeds and young plants for Christmas trees and timber as an expense.

6. The cost of chickens and plants used as food for your family is never deductible.

7. A farmer must capitalize the cost of plants with a pre-productive period of more than 2 years, unless you can elect out of the uniform capitalization rules.

8. If a farmer uses the crop method, the farmer can delay deducting the cost of seeds and young plants until the items are sold. However, the taxpayer must get IRS approval to use the crop method.

9. Generally, the farmer can adopt either the crop method or the cash method for deducting the cost in the first year that the former purchases egg-laying hens, pullets, chicks, or seeds and young plants.

F. Other Nondeductible Expenses

1. Loss of growing plants, produce, and crops. Losses of plants, produce, and crops raised for sale are generally not deductible. However, you may have a deductible loss on plants with a preproductive period of more than 2 years.

2. Loss of livestock. Losses on the value of raised livestock that died ARE NOT DEDUCTIBLE if you deducted the cost of raising them as an expense.

3. Cost of raising unharvested crops. A taxpayer cannot deduct the cost of raising unharvested crops sold with land owned more than 1 year if you sell both at the same time and to the same person. These costs are added to the basis of the land to determine the gain or loss on the sale.

4. Cost of unharvested crops bought with land. Capitalize the purchase price of land, including the cost allocable to unharvested crops. A taxpayer cannot deduct the cost of the crops at the time of purchase. However, a taxpayer can deduct this cost in figuring net profit or loss in the tax year the taxpayer sells the crops.

V. Active Trade or Business

A. Deductions of a sole proprietorship are not allowed if the activity has not risen to be an active trade or business.

Examples

Eason v. Comm., TC Summary 2024 – 17. The taxpayers attempted to start a business to provide advice and guidance to real estate owners and investors. They purchase courses through a company paying over $41,000. They also had business cards and stationery that they did not provide details of any other activity related to the business. After failing to provide many of the services that the taxpayer expected to receive, the taxpayers went out of business two years later. The cost incurred prior the starting of the business are generally capitalized under Section 195 in determining where is a business starts the business must function as a going concern and perform the activities for which it is organized.

Kamal v. Comm., TC Memo 2023 – 80. Taxpayers were not entitled to business deductions for expenses allegedly relating to the husband's consulting business because the taxpayers failed to demonstrate that they were engaged in an active trade or business. Husband claimed that payments from various clients were for business services or equipment provided by the taxpayers business to the so-called client. Allegedly there were service agreements between the client and the taxpayer's business and invoices were allegedly issued to demonstrate such services. Part of the problem is the invoices predated the incorporation of the business. Records also failed to indicate that the incorporated business provided any services or receive payments. Even if the consulting company was in fact operating deductions would still fail because they were not substantiated. These included depreciation, insurance expense, advertising, licenses, utilities, professional fees, meals and entertainment, travel, repair and maintenance. The incorporated business also did not have any bank records nor bank account reflecting any expenses or income reported.

Kellett v. Comm., TC Memo 2022 – 67. Taxpayer filed his return deducting 100% of business expenses related to a new social media website he developed. Of his Schedule C expenses $20,000 were paid for engineering services and the remainder of approximately $5,000 for telephone, Internet and marketing. The IRS disallowed all of the expenses as startup expenses because the taxpayer reported no business income for the tax year and he had not billed anybody for any services. The taxpayer explained that he launched the website opening it for public use in the tax year although he had no income collected in the first year of operations. The Tax Court indicated that in determining when an active trade or business begins a taxpayer does not begin caring on trade or business until such time as the business has begun to function as a going concern and perform the activities for which it was organized. The court determined a portion of the expenses were deductible. The court permitted approximately $8,000 of expenses paid after September of the tax year should advise the taxpayer that he could advertise under Section 195 remaining amounts over the code section provision.

Harrison v. Comm., TC Summary 2022 – 6. The taxpayer was a full-time employee of another corporation. The taxpayer was in the early stages of opening her own consulting business. She network and participated in speaking engagements to build up her brand and clientele. She also worked with the firm to set up her website. Section 162 does not permit deductions for startup or preopening expenses incurred by the taxpayer before beginning business operations. The court found the taxpayer's initial research and solicitation of potential clients will still exploratory in association with start of the business and did not rise to the level of caring on a trade or business.

VI. 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. Self Employed Retirement Plans

1. Calculating Earned Income for Self-Employed Individuals with Qualified Retirement Plans

a. 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.

b. 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

c. The SEI's contribution deduction is calculated as follows:

Contribution deduction = EI x Plan Rate.

d. 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))

e. 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.

2. Retroactive First Year Elective Deferrals

a. Effective for plan years beginning after Dec. 29, 2022, §317 allows plans sponsored by sole proprietors or disregarded single member limited liability companies (SMLLCs), in which the owner is the only employee, to receive employee contributions (deferrals) up to the date of the employee's tax return filing date for the initial year of the plan (without regard to extensions).

b. This provision is allowed for the first year of the plan only.

c. Under the original SECURE Act, an employer may establish a new 401(k) plan after the end of the taxable year, but before the employer's tax filing date (including extensions) and treat the plan as having been established on the last day of the taxable year. Those plans may only be funded by employer contributions up to the employer's tax filing date, including extensions.

3. Household Employers May Establish a SEP Plan for Nontrade or Non-Business Employees
Effective for taxable years beginning December 29, 2022.

a. Section 118 allows employers of domestic employees to provide retirement benefits for such employees under a simplified employee pension (SEP).

C. Form 7206: Employed Health Insurance Deduction

1. Form 7206 was introduced last year to report self employed health insurance deductions for self-employed individuals, partners subject to the SE tax and more than 2% S corporation shareholders claiming the self employed health insurance deduction.

2. The form replaces the worksheet that was in Publication 535.

3. The form is required if any of the following apply:

- Taxpayer or her spouse, if filing joint, have more than one source of income subject to self-employment tax.
- Taxpayer is filing Form 2555 or
- Taxpayer is using amounts paid for qualified long-term care insurance to figure the deduction.

4. Taxpayers will file a separate form for each trade or business under which a health insurance plan is established.

5. Taxpayers who have different health insurance during the year because of changing jobs may have to file more than one form.

6. The taxpayer is not to include any costs incurred for any month eligible to be covered by another employer plan for the taxpayer, spouse or dependents.

7. Note if an eligible employer plan does not cover long-term care benefits, a deduction is allowed for those premiums.

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169**.**

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION II:

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)

B. Property Qualifying for Section 179 Treatment

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 and 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 in 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 or the 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 the return**.**

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.

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:

- 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.

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

23rd Street Chelsea Associates, LLC ., v. Comm., 162 TC No. 3 (2/20/2024). The taxpayer began construction on a multi-family residential apartment complex. The construction was financed through to bond issuances. The taxpayer incurred $1.2 million of financing cost in securing the bonds. The taxpayer included the financing costs in the calculation of basis for purposes of depreciation. The IRS denied the inclusion of the financing cost in the basis stating that the proceeds from the bonds came from tax-exempt bonds. The Tax Court indicated uniform capitalization rules apply holding that the financing cost incurred by reason of the construction and before the end of the credit timeframe are includable in the basis for purposes of depreciation.

Johnson v. Comm., TC Memo 2023 – 116. The taxpayer was engaged in the business of buying, selling, and leasing real estate. He purchased a hotel and allocated $ 2.1 million to the commercial building. The allocation was based on a cost segregation report. The taxpayers improperly claimed depreciation amounted to 100% of the value of the building. The building would have been subject to 39 years depreciation. In

other words, the used an incorrect method of depreciation. It was determined that they took seven years MA CRS and took bonus depreciation which they are not allowed to take. The improper depreciation that was taken results in Section 481 adjustment.

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)).

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

IQ Holdings, Inc. v. Comm., TC Memo 2024 – 102. The taxpayer was allowed to deduct damage inventory as part of costs of goods sold. The IRS disallowance and reasoning as not clearly reflect the

income was incorrect Treasury Regulation 1.471 – 2 does not require the taxpayer to offer for sale items in their current condition that would be illegal to sell. The salability of the products as well as the taxpayer's knowledge as to whether the items could be rehabilitated allow for the write-off to occur.

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 usde the Cohan rule to determine cost of goods sold at 55% of sales while the tax return claim 82% in the IRS 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.

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.

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).

9. Repairs and Maintenance

Examples

Tibin v. Comm., TC Memo 2024 – 102. Taxpayer was entitled to deductions for repairs and maintenance and compensation over and above deductions provided by the IRS. The taxpayer substantiated these expenses under the Cohan rules. Other expenses such as office supplies, insurance and rent were not allowed due to the lack of substantiation.

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.

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.

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.

12. Advertising Expense

Examples

Avery v. Comm., 134 AFTR 2d 2024 – 5360 (CA – 10). The taxpayer used his racing car to advertise his law practice so he included car racing expenses on his Schedule C. The IRS rejected these expenses and assess a deficiency of almost $1 million. The Tax Court determined some the expenses were legitimate. However, the Tax Court disallowed the car racing expenses as they were not ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. On appeal, the 10th Circuit affirmed the Tax Court decision. The taxpayer argued on appeal that the Tax Court considered an impermissible factor, his enjoyment of car racing when the court deep decided that his car racing expenses were not deductible. The taxpayer claimed the Tax Court was not allowed to consider a taxpayers enjoyment of a marketing activity as part of the determination of whether expense is ordinary and necessary in nature. The 10th Circuit, you rejected the argument stating that personal enjoyment assists in determining the taxpayer's primary motive for incurring the expenses but it is just one factor to consider.

In determining whether these type of expenses are ordinary and necessary the Appeals Court looks at the following with respect to advertising:

- *Business connection.* There must be a clear link between the car-racing activity and the taxpayer's business.

- *Promotional intent.* The taxpayer must demonstrate that the car-racing activity is intended to promote the business.
- *Reasonable expense.* The amount spent on car-racing expenses must be reasonable in relation to the business' gross receipts or the expected benefits.
- *Business benefit.* The taxpayer should be able to demonstrate that the car-racing activities resulted in tangible benefits for the business, such as new business contacts, increased sales, or strengthened existing business relationships.

The 10th Circuit indicated that the taxpayer lost the car racing expense deduction as advertising because he failed to show that the primary purpose of his car racing was business promotion rather than personal enjoyment.

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.

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.

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 therestaurant 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.

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 that 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.

16. Fines and Penalties

Example

CCA 202439015. A taxpayer's court ordered payments to a government agency and court ordered customer debt forgiveness were nondeductible fines and penalties. Under the terms of the court order, the payments to the government agency were to be placed in an agency administered fund for consumer redress and equitable relief. Any remaining were to be deposited with the U.S. Treasury as disgorgement. Because the court order did not specify that the payments to the government agency or the customer debt forgiveness were "restitution" or "an amount paid to come into compliance with such law", the order did not meet the identification requirement under Code Sec. 162(f)(2)(A)(ii). Furthermore, the taxpayer failed to provide documentation to establish that the government agency's fund and the customer debt forgiveness, provided restitution to the victims harmed by the taxpayer as required by Code Sec. 162(f)(2)(A)(i).

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)

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

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 v. 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.

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.

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 and loss statements provided by the taxpayer were insufficient and unreliable.

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))

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 to different work locations, regardless of the distance, are deductible if the taxpayer also has one or more regular work locations away for the taxpayer's 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 business vs personal in nature. 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.

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. The 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.

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.

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. 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.

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)

2. For 2025, the standard mileage rate for deductible business expenses is $0.70 per mile (Notice 2025 – 05)

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. Excess 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. Lease 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.

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. The 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.

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.

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))

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.

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.

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.

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.

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.

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).

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.

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.

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.

Examples

Employee I performs services under an arrangement in which J, an employee leasing company, pays I a per diem allowance of $10x for each day that I performs services for J's client, K, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food or beverages that I pays in performing services as an employee. J enters into a written agreement with K under which K agrees to reimburse J for any substantiated reimbursements for travel expenses, including meal expenses, that J pays to I. The agreement does not expressly identify the party that is subject to the limitations on deductions in paragraph (a) of this section. I performs services for K while traveling away from home for 10 days and provides J with substantiation that satisfies the requirements of section 274(d) of $100x of meal expenses incurred by I while traveling away from home. J pays I $100x to reimburse those expenses pursuant to their arrangement. J delivers a copy of I's substantiation to K. K pays J $300x, which includes $200x compensation for services and $100x as reimbursement of J's payment of I's travel expenses for meals. Neither J nor K treats the $100x paid to I as compensation or wages.

I and J have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(B) of this section. Because the reimbursement payment is not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(B)(1) of this section, I is not subject to the limitations on deductions in paragraph (a) of this section. Instead, under paragraph (c)(2)(ii)(B)(2) of this section, J, the payor, is subject to limitations on deductions in paragraph (a) of this section unless J can meet the requirements of section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section.

Because the agreement between J and K expressly states that K will reimburse J for substantiated reimbursements for travel expenses that J pays to I, under paragraph (b)(7)(ii)(A) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. J accounts to K for K's reimbursement in the manner required by section 274(d) by delivering to K a copy of the substantiation J received from I. Therefore, under section 274(e)(3)(B) and paragraph (c)(2)(ii)(C)(2) of this section, K and not J is subject to the deduction limitations in paragraph (a) of this section.

Same as above except that, under the arrangements between I and J and between J and K, I provides the substantiation of the expenses directly to K, and K pays the per diem directly to I.(ii)Under paragraph (b)(7)(i) of this section, I and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because I substantiates directly to K and the reimbursement payment was not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(C)(1) of this section, I is not subject to the limitations on deductions in paragraph (a) of this section. Under paragraph (c)(2)(ii)(C)(2) of this section, K, the payor, is subject to the limitations on deductions in paragraph (a) of this section.

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!
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.)

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).

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. 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:

- 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
- 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

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.

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. **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.

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.

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.

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.

8. Rev. Proc. 2024 – 34 attempts to resolve timing issues for taxpayers who are making changes in method of accounting for specified research and experimental expenditures comply with the new amortization requirements. The original change in method of accounting rules did not covered taxpayers partial years. This procedure expanded the audit protection exceptions to be able to make changes in the final year of a business or when the same change was made within the previous five years.

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.

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.

D. Research Expense Accounting Method Changes – Rev. Proc. 2025 – 08, 2025 – 4 IRB

1. The IRS has issued further guidance for taxpayers that change accounting methods for their research and experimental expenses to comply with Section 174. The guidance extends the automatic consent to changes where R&E expenses incurred in 2024. The guidance also allows taxpayers to change your accounting method for such expenditures paid or incurred in 2024 regardless of whether they previously made the change for any tax years beginning in 2022, 2023 or 2024.

2. Before that Tax Cuts and Jobs Act, taxpayers could deduct research and experimental cost as current expenses or charge the expenses to a capital account in amortize and rightly over a period of not less than 60 months. Obviously, the Tax Cuts and Jobs Act amended Section 174 require that for such costs that are paid or incurred in a tax year beginning in 2022 and later years such cost must be amortized over either a five-year period for domestic research or a 15 year.

3. The new guidance on automatic consent changes is designed to address certain taxpayers that may not have been eligible to file automatic changes in methods of accounting for tax year beginning in 2024. The reason is there were waivers of the rules that apply to tax years in 2023 and 2024.

4. This current guidance provides the taxpayer may change their accounting method for tax year beginning in either 2022, 2023 or 2024 regardless of whether the taxpayer may change to the same item for any previous tax year in 2022, 2023 or 2024.

5. The Revenue Procedure is effective for Form 3115 filed on or after December 17, 2024.

E. New Form 6765 (December, 2024)

1. The new form was released and has Section G – Business Component Information which require up to 13 items of information. That information would include the following:

- EIN of controlled group member conducting research activities
- Controlled group member's principal business activity code
- Business component's name or unique alphanumeric identifier
- Business component type
- Software
- Description of information sought to be discovered
- Direct research wages for qualified services
- Direct supervision wages for qualified services
- Direct support wages for qualified services
- Total qualified wages
- Cost of supplies
- Rental or lease cost of computers
- Applicable amount of contract research expenses
- Section G will be optional for tax year 2024, but mandatory for tax year 2025 (processing year 2026).

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. Update on Cannabis Businesses

A. General

1. Despite the fact that a marijuana dispensary is in compliance with state law, the federal government considers that an illegal activity under the Federal Control Substances Act. Nonetheless, income from this source is taxable under Section 61 (a) of the Internal Revenue Code.

2. The federal courts have consistently upheld Internal Revenue Service determinations that state compliant marijuana dispensaries have taxable income. (See Olive v. Commissioner, 792 F.3d 1146 (9th Cir. 2015); Feinberg v. Commissioner, 916 F.3d 1330 (10th Cir. 2019); Beck v. Commissioner, T.C. Memo. 2015-149).

3. Similarly, illegal businesses have no exemption from their employment tax obligations.

4. A participant in the marijuana industry is subject to the same penalties and additions to tax as any other business.

B. Deductions Assisted with Selling Marijuana

1. Section 280E disallows all deductions or credits for any amount paid or incurred in carrying on any trade businesses that consist of illegally trafficking in a Schedule I or II controlled substance within the meaning of the federal Controlled Substances Act.

2. This applies to businesses that sell marijuana, even if they operate in states that have legalized the sale of marijuana, because trafficking marijuana remains illegal under the federal Controlled Substances Act. (See United States v. Oakland Cannabis Buyers' Co-op., 532 U.S. 483 (2001)).

3. Likewise, Section 280E disallows all deductions or credits for a business that sells or otherwise traffics marijuana. (See N. California Small Bus. Assistants Inc. v. Commissioner, 153 T.C. 65 (2019)).

4. Section 280E does not prohibit a participant in the marijuana industry from reducing its gross receipts by its properly calculated cost of goods sold to determine its gross income. The Internal Revenue Service takes the position that Section 280E taxpayers must calculate their cost of goods sold pursuant to Internal Revenue Code Section 471 and the associated Treasury Regulations.

5. Generally, this means taxpayers who sell marijuana may reduce their gross receipts by the cost of acquiring or producing marijuana that they sell, and those costs will depend on the nature of the business. (See Chief Counsel Advice 201504011).

C. Cash Payments over $10,000 and Form 8300

1. Presently trade or businesses including marijuana businesses must report cash receipts rather than $10,000 single transaction or a related transaction. This means that likely Form 8300 will have to be utilized by these businesses.

Example

Patients Mutual Assistance Collective Corporation, Inc. v. Comm., TC Memo 2024 – 98. Taxpayers marijuana business were denied deductions for ordinary and necessary business expenses and charitable contributions. The court determined that Section 280 E is constitutional. The taxpayer was a corporation that operated a medical cannabis dispensary licensed under the state of California IRS issued a Notice of Deficiency where they deducted ordinary and necessary business expenses that were not cost of goods sold. The Control Substance Act was held to be constitutional in regards the denial of these deductions.

XIII. 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.

Examples

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 and was not at risk for either of these transactions and were thus not allowed the NOL deductions.

XIV. Employer Fringe Benefits

A. Employer Educational Assistance Programs and Student Loan Payments – IR – 2024 – 227

1. The IRS has issued guidance to employers who may offer tax-free benefits to employees up to $5,250 per year per employee for paying down student loan debt.

2. The temporary allowance for this program does result in the exclusion of income. This program started under the CARES Act and ends December 31, 2025.

3. Section 127 (c) (1) (B) allows employers to pay principal interest on employees qualified education loans. Payments made directly to the lender as well as those made to the employee qualify.

4. The educational benefits are excludable from gross income are not subject to federal withholdings, Social Security tax and Medicare tax.

5. This code section also governs an employer providing educational benefits associated with tuition, school supplies. It is merely an expansion of the old program. The plan does require it to be in writing and provided to employees that are eligible. It can apply to undergraduate or graduate level education. Publication 5993 offers a sample written plan.

XV. Certain Businesses Required to E-file Form 8300: Report of Cash Payments over $10,000 received in a Trade or Business. – IR 2023 – 157.

A. General Rule

1. Effective January 1, 2024, businesses must e-file Form 8300 they are required to e-file certain other information returns electronically. The form requires a person report cash transactions of more than $10,000 by filing Form 8300: Report of Cash Payments over $10,000 received in a Trader Business.

2. Persons consist of individuals, companies, corporations, partnerships, associations, trusts or states offering a trade or business. It also includes tax-exempt organizations. Tax-exempt organizations are not required to file the form for a $10,000 charitable cash contribution to the charity.

3. The new e-file requirement begins January 1, 2024 and the taxpayer must file the form if there required to e-file at least 10 other information returns.

4. In addition to filing the form, the taxpayer will need to provide a written statement to each party whose name on the Form 8300 by January 31 of the year following the reportable transaction. This statement must include the name, address, contact person and telephone number of your business and the aggregate amount of reportable cash. The statement must also indicate that the taxpayer provided this information to the IRS. Those who are required to file the form and do not try by a written statement to each person named on the form are subject to penalties which will be adjusted annually for inflation.

a. Note: Form 8300 can also be filed due to suspicious activities. A box can be checked on the form for this purpose. In that event, the statement is not provided to those identified on the form.

4. A person must file within 15 days after receiving reportable cash. Reportable cash includes multiple cash payments of less than $10,000 paid toward a single transaction or two or more related transactions. If a business receives later payments toward a single transaction or 2 or more related transactions, the business

will file Form 8300 when the total amount exceeds $10,000. Each time payments aggregate more than $10,000 the business must file another Form 8300.

5. The filing of the form is an information return requirement subject to the reduced thresholds of 10 or more that must be filed electronically. A copy of Form 8300 must be retained by the taxpayer along with supporting documentation for five years from the date of the e-filing. The form is filed electronically using the Financial Crimes Enforcement Networks BSA E-filing System. Businesses must set up an account to file electronically.

a. For information to file electronically the client can call 866 – 346 – 9478 or email at BSAEFilingHelp@fincen.gov.

6. Businesses can submit Form 8508: Application for Waiver of Electronic filing Information Returns. The service indicates that if the waiver is granted it applies to all information returns for a calendar year. Waiver requests can't be submitted only for Form 8300. If the waiver is granted they would mail the form to Internal Revenue Service, Federal Building, and PO Box 32 61, Detroit, Michigan 48232.

7. There are significant penalties ranging from failure to file to intentional disregard and willfulness. It appears penalties range from a minimum of $10,000 all the way up to $100,000.

B. Types of Payments Reported

1. Trades and businesses must report cash payments received if the following criteria are met:

- The amount of cash received is greater than $10,000.
- The business receives the cash as one lump sum of more than $10,000 or installments causing the total amount received within one year of the initial payment to be more than $10,000 for previously unreported payments causing the total cash received within a 12 month period to total more than $10,000.
- The establishment receives the cash in the ordinary course of a trade or business
- The same agent or buyer provides the cash.
- The trade or business receives the cash in a single transaction or in related transactions.

Examples

Bubba buys a new car and sells his old one for $12,000. The buyer of the car pays in cash. Bubba is not in the business of selling cars so he is not required to report the receipt of the cash over $10,000.
Bubba is a travel agent a client pays $8000 upfront cash for a trip. Two days later, the same client pays $3000 more in cash to include another person. They are related transactions and must file the form.

C. Cash Defined

1. Cash includes the coins and currency of the United States and a foreign country. Cash may also include cashier's checks, bank drafts, traveler's checks, and money orders with a face value of $10,000 or less, if the business receives the instrument in:

- A designated reporting transaction, or
- Any transaction in which the business knows the customer is trying to avoid reporting of the transaction on Form 8300.

Examples

Bubba buys a used car from ABC Dealership for a price of $12,000. Bubba pays with the cashier's check having a face value of $12,000. The cashier's check is not treated as cash because it's face value is more than $10,000, the business does not need to file the form.

Bubba buys the car from the used car dealership for $12,000 but has a cashier's check for $6,000 and pays the remaining balance of $6,000 in cash. The business is required to file the form because the monetary instrument of $6,000 in the cash are both under $10,000 but when combined make , the transaction more than $10,000.

2. A designated reporting transaction is the **retail sale** of any of the following:

- A consumer durable such as an automobile, boat, or property other than land or buildings:
  - Suitable for personal use
  - Can reasonably be expected to last at least one year under ordinary use
  - Has sales price of more than $10,000
  - Can be seen or touched (tangible property)
- A collectible such as a work of art, rug, antique, metal, gems, stamps, or coins.
- Travel or entertainment, if the total sales price of all items sold for the same trip or entertainment event in one transaction or related transactions is more than $10,000. The total sales price of all items sold for a trip or entertainment event, which includes the sales price of items such as airfare, hotel rooms and admission tickets.

Example

Bubba asked a travel agent shoot charter an airplane to take a group to a sports event in another city. He asked the travel agent to book hotel rooms and obtain tickets for the sporting event for the entire group. He pays with two money orders of $6,000 each. The travel agent has received more than $10,000 cash in a designated reporting transaction and must file the form.

3. Cash does not include:

- Personal checks drawn on the account of the writer.
- A cashier's check, bank draft, traveler's check or money order with a face value of more than $10,000.
- Any transmittal of funds from financial institution including a bank or a money service business.

When a customer uses currency of more than $10,000 to purchase a monetary instrument, the financial institution issuing the cashier's check, bank draft, traveler's check or money order is required to report the transaction by filing the FinCEN Currency Transaction Report (CTR).

Example

Bubba buys an automobile from ABC dealers for $19,000. He pays with $4000 in currency and wire transfers $15,000 from his bank to the dealerships bank account. A wire transfer does not constitute cash for reporting purposes since the remaining cash remitted to the dealership was below $10,000 the dealer has no filing requirement.

- A cashier's check, bank draft, traveler's check or money order received in payment on a promissory note or an installment sales contract (including a lease that is considered a sale for federal tax purposes). However, this exception applies only if:

  - The business uses similar notes or contracts in other sales to ultimate customers in the ordinary course of its trade or business and
  - The total payments for the sale the business receives on or before the 60th day after the sale are 50 percent or less of the purchase price.

- A cashier's check, bank draft, traveler's check, or money order received in payment for a consumer durable or collectible, and all three of the following statements are true:

  - The business receives it under a payment plan requiring:
    - One or more down payments and
    - Payment of the rest of the purchase price by the date of sale.
  - The business receives it more than 60 days before the date of the sale.
  - The business uses payment plans with the same or substantially similar terms when selling to ultimate customers in the ordinary course of its trade or business.

D. Related Transactions Defined

1. The law requires trades and businesses report transactions when customers use cash in a single transaction or a related transaction. Related transactions are transactions between a payer, or an agent of the payer, and a recipient of cash occurring within a 24-hour period. If the same payer makes two or more transactions totaling more than $10,000 in a 24-hour period, the business must treat the transactions as one transaction and report the payments. A 24-hour period is 24 hours, not necessarily a calendar day or banking day.

Example

A retail motorcycle dealer sells a motorcycle for $9,000 in cash to Gary Smith at 10 a.m. During the afternoon on the same day, Mr. Smith returns to buy another motorcycle for his son and pays $9,000 in cash. Since, both transactions occurred within a 24-hour period, they are related transactions, and the motorcycle dealer must file Form 8300.

2. Transactions are related even if they are more than 24 hours apart when a business knows, or has reason to know, each is a series of connected transactions.

Example

A client pays a travel agent $8,000 in cash for a trip. Two days later, the same client pays the travel agent $3,000 more in cash to include another person on the trip. These are related transactions, and the travel agent must file Form 8300.

E. Tax Identification Number (TIN) Requirement

1. A business must obtain the correct TIN of the person(s) from whom they receive the cash.

2. If the transaction is conducted on behalf of another person or persons, the business must also obtain the TIN of a person or persons.

3. Failure to include all required information or inclusion of incorrect information, on Form 8300, may result in civil or criminal penalties. However, a filer may be able to avoid penalties when the customer refuses to provide a TIN by showing its failure to file is reasonable under circumstances more fully described in 26 CFR 301.6724-1(e) and (f).

4. A filer is not required to provide the TIN of a person who is a nonresident individual or foreign organization. However, name and address verification is required, and the source of the verification must be included in item 14 of Form 8300. For nonresident aliens, acceptable documentation would include a passport, alien registration card or other official document.

F. Suspicious Transactions Reporting

1. The form allows for the taxpayer to report business transactions that are of a suspicious nature where it appears a person is trying to prevent a business from filing the form, it appears a person trying to cause the business to file a false or incomplete form or there is a signal of a possible illegal activity.

2. The business may make a report of these suspicions transactions by checking the suspicious transactions box on the form. The business may voluntarily file the form in situations with the transaction is $10,000 or less and suspicious.

G. Reporting Payments

1. The amount of cash a customer uses for a transaction and when the customer makes the transaction are the determining factors for when the business must file the Form 8300. Generally, a business must file Form 8300 within 15 days after they receive the cash. If the 15th day falls on a Saturday, Sunday, or holiday the business must file the report on the next business day.

Example

John, an attorney receives more than $10,000 cash from a person as advance payment for legal services. Even though no service has been performed at the time the cash is received, the attorney is required to file Form 8300 within fifteen days after the cash is received. Once a person receives (in a transaction or related transactions) cash exceeding $10,000 in a person's trade or business, a Form 8300 must be filed.

2. The event the payer arranges to pay in installments, if the first payment of installments more than $10,000 the business must file the form within 15 days. If the first payment is not more than $10,000, the business as the first payment and any later payments made within one year the first payment. When the total payments exceed $10,000 before must be filed within 15 days.

3. After a business files the first form 8300, it must start a new count of Cash payments received from the pay your or buyer. If a business receives more than $10,000 in additional cash payments from the buyer within a 12 month timeframe, it must file another Form 8300 within 15 days of the payment causing the additional payments to total more than $10,000.

4. The business must file form 8300 in the same customer makes additional payments within the 15 days before the business files Form 8300, the business can report all the payments on one form.

Example

On January 10, a customer makes a cash payment of $11,000 to a business. The same customer makes additional payments on the same transaction of $4,000 on February 15, $5,000 on March 20, and $6,000 on May 12. By January 25 (fifteen days from January 10), the business must file Form 8300 for the $11,000 payment. By May 27 (fifteen days from May 12), the business must file another Form 8300 for the additional payments totaling $15,000.

5. Businesses can use Form 8300 electronically using the Bank secrecy act electronic filing system. However, effective January 1, 2024 businesses must electronically file the form if there required to file other information returns electronically. The option out would be through a waiver.

6. Businesses for reporting purposes include sole proprietorships located in the US and US territories. The US territories include America Mola, Guam, Puerto Rico and the US Virgin Islands.

7. Members of the consolidated group are required to file the form the information specific to that member corporation is provided in Part IV of the form.

8. If the person who files Form 8300 is related to the individual who gave the cash or related to the person on whose behalf the transaction was conducted to persons filing the form must include the words Related Party Transaction in the comment section.

H. Required Written Statements for Customers

1. When a business is required to file a Form 8300, the law requires the business to provide a written statement to each person(s) named on Form 8300 to notify them the business has filed the form. This requirement to provide a written statement does not apply with respect to a Form 8300 filed voluntarily, including a Form 8300 to report a suspicious transaction involving less than $10,000.

2. The statement must include the following information:

- The name and address of the cash recipient's business,
- Name and telephone number of a contact person for the business,
- The total amount of reportable cash received in a 12-month period, and
- A statement the cash recipient is reporting the information to the IRS.

3. The code and regulations only specify the information the business is required to include on a statement, not the format of the statement. A business may use its invoice for the statement of notification, as long as the invoice includes all required information. Providing a copy of Form 8300 to the payer(s), although not prohibited, is not advisable due to the sensitive information contained on the form, for example, the Employer Identification Number (commonly called an EIN) or SSN of the filer.

4. The business filing Form 8300 must provide its identified customers and all parties on the form that are part of the transaction with the written statement **on or before Jan. 31** of the year immediately following the year the customer made the cash payment.

I. Cannabis Businesses – CCA 202409016.

1. The Chief Counsel Advisory indicates that cannabis businesses may be cash intensive businesses and may be subject to Form 8300 reporting.

2. The CCA does discuss reasonable cause for failing to timely file Form 8300. No penalty shall be imposed if it is shown the failure is due to reasonable cause and not willful neglect. A reasonable cost would be some mitigating factor or failure to file that is be on the filer's control.

XVI. Employer Shared Responsibility Penalty

A. General Rule

1. An applicable large employer with 50 or more full-time equivalent employees continues to be required to provide adequate and affordable health coverage to its full-time employees. The failure to do so would expose the employer to the Employer Shared Responsibility Tax.

2. There are two types of employer shared responsibility payments:

- If an applicable large employer does not offer minimum essential coverage to at least 95% of its employees and their dependents and at least one full-time employee receives the premium tax credit for purchasing coverage through the Health Insurance Marketplace, the penalty is $2000 indexed for inflation. The penalty does not apply to the first 30 employees but applies to the employer's entire workforce.
- Even if an applicable large employer offers minimal essential coverage it may still be exposed to the penalty for each full-time employee who receives the premium tax credit for purchasing coverage the marketplace.

For 2024, the $2.000 indexed for inflation is $2.970.

3. A full-time employee could receive the premium tax credit if:

- the minimum essential coverage the employer provides to the employee is not affordable
- the minimum essential coverage the employer offers to the employee does not provide minimum value or
- the employee is not one of the at least 95% full-time employees offered minimal essential coverage.
- In that particular case the penalty $3.000 and is also indexed for inflation.

For 2024, that is $4,460.

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169**.**

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION III:

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.

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.*

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:

- 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.

- 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.

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"

Prior Filing Deadlines

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.

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.

New Filing Deadlines!

December 26, 2024

1. On December 26, the full 5th Circuit vacated a prior decision by three-member panel on December 23, 2024 which granted the government's motion to lift the injunction the Texas Top Chop Shop, Inc. v. Garland, No. 4:24 – CB – 478, 2024 WL 504-9220. As such, the previous injunction against enforcement of the Corporate Transparency Act is back in play.

2. In plain English, FinCEN is again enjoined from enforcing the Corporate Transparency Act. As of today, the BOIR filing deadlines are now uncertain and entities subject to the January 13, 2025 filing date are no longer bound to file on that date.

3. The Fifth Circuit has not established timelines for hearings on this yet. I do not anticipate such occurring before the President-elect takes office.

December 23, 2024

1. Following a December 23, 2024 Fifth Circuit Court of Appeals Decision, most reporting companies are now required to file the Beneficial Ownership Information Reports (BOIR) with FinCEN . The Department of treasury has extended the reporting time as a result of this late decision

2. For those Reporting Companies created or registered prior to January 1, 2024 – these entities now have until January 13, 2025 to file their initial reports.

3. For Reporting Companies created or registered on or after September 4, 2024 – these entities now have until January 13, 2025 to file.

4. If a Reporting Company was create or register between December 3, 2024 and December 2 three, 2024, these reporting entities have an additional 21 days from the original filing to submit their reports.

5. For Reporting Companies that qualify for disaster relief, there reporting deadline has been extended beyond January 13 should adhere to a later deadline subject to qualified disaster reporting as determined by FEMA

6. For Reporting Companies trade or registered on or AFTER January 1, 2025, they must file their initial report within 30 days of receiving actual or public notice that the creation or registration is effective.

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.

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.

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 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)

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)

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.

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

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:

- 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
- 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

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.

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)

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.

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)

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.

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.

(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.

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.

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.

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:

- 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. 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.

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.

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.

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.

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.

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 Finalized Rules Regarding Nonfinancial Purchases of Residential Real Estate s Transfers – RIN 1506 – AB 54

a. FinCEN has finalized rulemaking new rules requiring certain persons involved in real estate closings and settlements to submit reports and keep records on identified non-financial transfers of residential real property to specified legal entities and trusts on a nationwide approach. Reporting obligation will be 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. 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. A transfer of ownership interest encompasses sales as well as nonsale transfers. Nonsale transfers would include 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 regulation would exempt the following transfers:

- Transfers made directly to individuals
- An extension of credit secured by the real property
- A revocation, transfer or granting of an easement
- A transfer by death or from death of an individual whether pursuant to the terms of a will or trust, operation of law or contractual provision
- A transfer incident to a divorce
- A bankruptcy
- A transfer made by a court in the United States
- A transfer made for no consideration by the individual either alone or with their spouse to a trust of which the individual, their spouse or both of them are the Grantors
- A transfer to an qualified intermediary for purposes of a Like Kind Exchange.

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:

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.

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. This would be effective for transfers occurring on or after December 1, 2025.

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.

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.

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.

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.

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.

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.

(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. 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.

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:

(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.

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.

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.

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.

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:

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.*

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:

- 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.

8. Director of a Board

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:

- *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)

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.

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. 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.

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.

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

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.

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.

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.

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

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. 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.

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:

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.*

(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?

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.

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)

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.

E. Dispute Over Ownership

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)

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.

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.

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.

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.

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.

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.

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. 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.

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.

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.

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.

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.

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.

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.

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**.

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. 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:

- 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).

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

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. 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.

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.

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:

- 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.

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.

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 .

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.

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.

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.

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

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.

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. 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.

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. 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.

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.

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.

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

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.

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.

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.

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).)

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:

- 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.

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.

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.

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.

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.

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.

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.

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.

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.

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.

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?

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.

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.

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. 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.

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.

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.

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. 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.

2. 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.

3. 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.

C. Gargasz LPA et al v. Yellen (Case 1.23 – CD – 02468 – CEF; US DC Northern District of Ohio)

1. The plaintiffs challenge the enforcement of the Corporate Transparency Act on constitutional grounds similar in nature to National Small Business United v. Yellen. The District Court entered an order staying the proceedings pending the 11th Circuit Appeal case in the Alabama decision.

D. William Boyle v. Yellen (Case 2:24 – CB – 00081)

1. This is a recent lawsuit challenging the constitutionality of the Corporate Transparency Act as infringing upon state sovereignty. The lawsuit argues the primary authority to charter and govern corporate entities rests with the states. By imposing a federal standard for incorporation, the Corporate Transparency That allegedly oversteps congresses powers and contravenes the principles of federalism and state autonomy.

2. The regulation allegedly lies outside Congresses enumerated powers, such as managing foreign affairs, regulate commerce or levy taxes. The lawsuit indicates the formation of reported company is described as a local act that bears no relation of foreign affairs or national security, noting that many companies may not partake in commerce across state lines with foreign nations or Indian Tribes.

E. Small Business Association of Michigan v. Yellen , US District for W D Mich, March 26, 2024

1. The Small Business Associate Michigan in several limited liability Is individuals brought a suit challenging the Corporate Transparency At on constitutional grounds. The lawsuit request immediate relating to Hall compliance requirements the complaint requests the court declared the Act unconstitutional

and grant preliminary injunctive relief against enforcement. The District judge presiding denied immediate relief.

2. The Michigan suit argues that the Act provides warrantless and suspicion less searches of American citizens and companies and violates the US constitutional protections under the Fourth Amendment. The complaint further alleges is that the Act is unconstitutional a bag and therefore void. The Complaint indicates that the definition of a beneficial owner *includes anyone who exercises substantial control over an entity whether directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise.* The lawsuit argues that the vagueness requires American citizens accompanies to guess how much control is substantial and what sorts of relationships or otherwise qualify as control sufficient to require all reporting for risk the imposition of penalties. The lawsuit further states that privacy matters are the concern because many state, federal and foreign agencies will be able to access the information furnished.

F. Texas Top Chop Shop, Inc. v. Merrick Garland (Case No. 4:24 – CB – 00478 – ALM; US District Court, Eastern District of Texas)

1. The Plaintiffs are challenging the enforcement of the Corporate Transparency On constitutional grounds seeking an injunction prohibiting the government from enforcing the act and the reporting roles in a declaratory judgment invalidating the Act in its entirety and wholly unlawful in setting aside the reporting Rules. The relief sought in this case goes beyond the Plaintiffs but to all parties currently affected by the reporting requirements. On June 3, 2024 plaintiffs filed a motion for preliminary injunction prohibiting defendants from enforcing the Implementing any further regulations or proceedings. A court hearing has not been set on this matter.

2. Update

a. On December 2 three, 20248 three-member panel of the Fifth Circuit Court of Appeals overturned the District Court's decision and lifted the preliminary injunction. The preliminary injunction was a nationwide injunction enjoining the Corporate Transparency Act from being enforced on grounds that it was unconstitutional in nature. The government filed an emergency motion with the court seeking a stay in the Fifth Circuit granted the stay.

b. The Fifth Circuit in granting the Government stay and temporary relief indicated that the government would likely be able to show that the Corporate Transparency Act is constitutional because the statute was based upon broad authority granted Congress under the Commerce Clause to regulate economic activity. In this particular case entities were required report their beneficial ownership interest in order to target the illicit financial activity. This group being regulated is part of an economic class of activity that has a substantial effect on interstate commerce. As such, the Court indicated that these entities fall with in more than a century of the Supreme Courts Commerce Clause Jurisprudence.

c. The Corporate Transparency Act reporting requirements are in association with entity's ability and propensity to engage in commercial activity. None of the businesses in this case have claimed they do not engage in a commercial or economic activity. The court also noted that the act also allows the federal government to exempt other entity or classes of entities which do not serve the public interest and which would not be useful in efforts to detect, prevent or prosecute money laundering, financing of terrorism, tax fraud and other crimes.

D. The Fifth Circuit indicated that the enactment of the Corporate Transparency Act was within congresses rational basis that such activity substantially affects interstate commerce and was within congresses power to pass.

G. Black Economic Council of Massachusetts, Inc. v. Yellen (Case No. 1:24 – CB – 11411 – PBS)

1. The plaintiffs seek to declare the Corporate Transparency Act unconstitutional and attain a permanent injunction enjoining defendants and any other federal agencies or employees acting on behalf of the Defendants reinforcing any provisions of the Act against any individual, applicant or entity. The request goes beyond plaintiffs in the case to all parties currently affected by the reporting requirements. This is a most recently filed case in Texas above.

H. Community Associations Institute v. Yellen 2024 WL 457-1412 (ED Va. October 24, 2024).

Plaintiffs are comprised of an organization representing various community associations across the United States. They filed a petition seeking injunctive and declaratory relief to prevent the enforcement of the Corporate Transparency Act. The plaintiff levied numerous challenges including violations of Administrative Procedure Act in which the treasury was exceeding its authority as well as first and fourth amendment violations of the Constitution. The plaintiffs argued that they are entitled to relief from the reporting obligations because they fall under the exception to the definition of reporting companies for nonprofit associations.. Specifically, any organization that is eight section 501 (c) organization of the Internal Revenue Code and exempt under Section 501 (a) is not encompassed within the term of the definition of a "reporting company" and therefore need not report beneficial ownership information. The plaintiffs cannot rely solely on Section 501 of the Internal Revenue Code to demonstrate that they are covered by the exemption. Section 501(c) lists 29 different types of organizations that are exempt under Section 501(a). Section 501(a) simply grants tax-exempt status to those organizations therefore listed. Plaintiffs are not included in those organizations as described in Section 501(c). Plaintiffs argue in the alternative that the FAQs on the FinCen website in terms of require reporting violate the Administrative Procedures Act. Specifically, when FinCen put the rules out for commentary the responses were arbitrary and capricious. The court indicated that this does not extend FAQs. Specifically, FAQs are not final agency action. The plaintiffs argued that the reporting requirement was a violation of free speech and the First Amendment, freedom of association and fourth amendment violations of search and seizure. The court did not agree with either those arguments and elected not to issue an injunction.

XVII. Differences in Reporting Between FinCEN and Financial Institution Reporting

A. Notice to Financial Institution Customers on Beneficial Ownership Information Requirements

1. The Treasury announced on July 26, 2024 a notice to customers of financial institution about reporting beneficial ownership information. The notice provided answers to questions as to whether the reporting required by taxpayers is the same as financial institutions.
2. The answer is they are not the same. Having said that, both collect beneficial ownership information from entities. However, they collect that information for different reasons and may collect different types of information. The notice spelled out the differences in terms of information gathering between FinCEN and Financial Institutions.

B. Differences in Reporting

1. Banks are required to collect certain information from their customers and reported to the treasury (FinCEN). The differences in reporting consist of the following:

- Financial Institutions are required to include the Social Security number of their customer, FinCEN is not asking for that information.

- Financial Institutions are not required to ask for a unique identifying number such as a passport or state driver's license, FinCEN is asking for that information.

- Financial Institutions are not required to ask for an assumed name or a DBA but FinCEN is asking for that information.

- Financial Institutions do ask about the type of business entity, FinCEN is not asking about the type of business entity.

- Financial Institutions do not ask about the jurisdiction of formation or registration, FinCEN is asking for that information.

- Financial Institutions do not ask about the company applicant nor do they require a certification of a complete report.

- Financial Institutions ask about the individual or individuals opening the bank account. FinCEN is not asking for that information.

- Financial Institutions certify that to the best of the individual's knowledge the information on opening the bank out is true and correct. This is not applicable in the beneficial ownership information reporting requirements.

2. Differences in How beneficial Ownership is Defined

a. Financial Institution Collection. A single individual with significant responsibility to control, manage or direct a legal entity customer, including executive officer or senior officer, manager or any other individual who performs similar function and each individual if any who directly or indirectly through any contract, arrangement, understanding, relationship or otherwise owns 25% or more the equity interest of the legal entity customer. Under this approach the financial visitation is only required to collect information about one individual with respect to the control aspect it may be collecting information as stated up to four individuals.

b. FinCEN Reporting. An individual who directly or indirectly exercises substantial control over reporting entity or who can trolls or owns at least 25% of the ownership interest of the reporting entity. There are no maximum number beneficial ownerships who must report

3. Notice to Financial Institution Customers

a. FinCEN on July 26, 2024 issued a notice clarify that financials Touche and customers may be required report BOI to FinCEN directly as well as to their financial institution as part of the federal customer due diligence requirements. The notice indicated that the information was being collected for different reasons if an entity is required to report beneficial ownership information that requirement cannot be fulfilled by providing information solely to a financial institution.

b. The example given is that entity seeks to open a bank account, the bank may require certain information about the entity's beneficial owners before the account is opened. That information is collected by the bank

not by FinCEN when fulfilling its federal customer due diligence obligations. That entity may separately be a reporting company that is required to report beneficial ownership information to FinCEN.

References:

HR 2513, Corporate Transparency Act of 2019

PL 116 – 283, Anti-Monitoring Laundry Act of 2020

FinCEN ;www.fincen.gov

SECTION IV:

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.

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.

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.

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,

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.

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:

- 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

VI. Small Employer Pension Plan Start Up Cost Credit

A. General Rules

1. The credit for a small employer starting a pension plan such as a 401(k), 403(b), SEPe IRA or SIMPLE IRA has been increased under the Tax Cuts and Jobs Act. For the first credit year in each of the two taxable years and neatly following the first credit year, the credit is 50% of plan start cost limited to the greater of:

- $500 or
- $250 for each employee of the eligible employer who is not a highly compensated employee and who is eligible to participate in the plan maintained by the employer or $5,000

2. The pension plan start cost must be reduced by the amount of the credit allowed.

3. An additional $500 credit is allowed the plan has an automatic enrollment feature.

B. SECURE 2.0

1. This increased the above credit for very small employers defined is 50 or fewer employees to be 100% of the plan start up costs.

2. The act also established an additional credit for all or a portion of employer contributions for the first five years from the establishment of the plan.

3. The additional credit does not apply to defined benefit plans. The credit is a percentage of the employer contribution limited to $1000 per employee.

4. The percentage of the employer's contribution is as follows:

- 100% for the first two years,
- 75% in the third year,
- 50% in the fourth year and
- 25% in the fifth year.

Note: no credit is allowed after the fifth year.

5. The credit is reduced from floors with 51 to 100 employees by 2% for each employee over age 50 and no credit is allowed for employers with over 100 employees.

6. No present laughter any employee who earns more than $100,000 a year.

VII. Employer Provided Childcare Tax Credit – IR 2024 – 34

A. General Rule

1. In order for an employee to claim this new credit they must have paid or incurred qualified childcare expenditures designed to provide childcare services to employees.

2. The credit is 25% of qualified childcare facility expenditures +10% of qualified childcare resources and refer expenditures limited to $150,000 per year.

3. The credit is claimed on Form 8882: Credit for Employer Provided Childcare Facilities and Services and it flows as part of the Gen. Business Credit – Form 3800.

B. Qualified Childcare Expenditures

1. Qualify Childcare Expenditures or costs associated with acquiring, constructing, rehabilitating or expanding property used as the taxpayers qualified childcare facility.

2. . Qualified childcare facility expenditures are operating expenses made by the taxpayer, including amounts paid to support childcare workers through training, scholarship programs, and providing increased compensation to employees with higher levels of childcare training; and qualified resource and referral expenditures which include amounts paid or incurred under a contract with a qualified childcare facility to provide childcare services to employees of the taxpayer.

3. The requirements for a qualified childcare facility:

- Principal use must be to provide childcare assistant (unless it is a person's primary residence)
- Must be open to employees during the year
- If the facility is the principal business of the taxpayer, at least 30% of the enrollees must be
- dependents of the taxpayer's employees
- No discrimination in favor of highly compensation employees (§414(q))

4. Qualified childcare facility expenditures are amounts paid or incurred:

- Acquire, construct, rehabilitate or expand property that is:
- To be used as part of a qualified childcare facility of the taxpayer
- Depreciable (or amortizable) property
- Not part of the principal residence of the taxpayer or any employee of the taxpayer
- To operate a qualified childcare facility of the taxpayer. This includes training employees,
- providing scholarship programs, and providing increased compensation to employees with higher
- levels of childcare training.

5. Qualified resource and referral expenditures are amounts paid or incurred under a contract to provide childcare resource and referral services to your employees. The provision of the services (or the eligibility to use the services) must not discriminate in favor of highly compensated employees

VIII. Elective Pay and Transferability

A. Introduction

1. Elective pay allows applicable entities (as defined), including tax-exempt and governmental entities that would otherwise be unable to claim these credits because they do not owe federal income tax, to benefit from some clean energy tax credits by treating the amount of the credit as a payment of tax and refunding any resulting overpayment.

Example

A local government that makes a clean energy investment that would qualify for the investment tax credit can file an annual tax return with the IRS to claim elective pay for the full value of the investment tax credit as long as it meets various requirements including a prefiling registration. Since the local government would not owe any other federal taxes, the IRS would make a refund payment in the amount of the credit to the local government.

2. The transferability allows a taxpayer who generated certain clean energy tax rates to elect to transfer all or a portion of the credit to an unrelated third party transferee in exchange for cash. The buyer and sellers negotiate and agree to the terms and pricing.

3. Only applicable entities are eligible for an can use the elective pay applicable entities include nclude tax-exempt organizations, states, and political subdivisions such as local governments, Indian tribal governments and their subdivisions, Alaska Native Corporations, the Tennessee Valley Authority, rural electric cooperatives, U.S. territories and their political subdivisions, and agencies and instrumentalities of state, local, tribal, and U.S. territorial governments.

4. The final regulations provide that any organization described in Sections 501 through 530 that meets the requirements to be recognized as exempt from tax under those sections is eligible for elective pay. This includes, among others, all organizations described in Section 501(c), such as public charities, private foundations, social welfare organizations, labor organizations, and business leagues. It also includes homeowners associations exempt under Section 528.

5. As previously indicated, only applicable entities are eligible for elective pay. However, there are special rules for three of the clean energy tax credits. Specifically, taxpayers that are not "applicable entities" may make an election to be treated as an applicable entity for elective pay (in these FAQs those entities are described as "electing taxpayers") with respect to applicable credit property giving rise to:

- the section 45Q credit (credit for carbon oxide sequestration),
- the section 45V credit (credit for production of clean hydrogen), or
- the section 45X credit (advanced manufacturing production credit).

6. The following applicable credits are eligible for elective pay:

- Energy Credit (48), (Form 3468, Part VI)
- Clean Electricity Investment Credit (48E), (Form 3468, Part V)
- Renewable Electricity Production Credit (45), (Form 8835, Part II)
- Clean Electricity Production Credit (45Y)
- Commercial Clean Vehicle Credit (45W), (Form 8936, Part V)
- Zero-emission Nuclear Power Production Credit (45U), (Form 7213, Part II)
- Advanced Manufacturing Production Credit (45X), (Form 7207)
- Clean Hydrogen Production Credit (45V), (Form 7210)
- Clean Fuel Production Credit (45Z)
- Carbon Oxide Sequestration Credit (45Q), (Form 8933)
- Credit for Alternative Fuel Vehicle Refueling / Recharging Property (30C), (Part 8911, Part II)
- Qualifying Advanced Energy Project Credit (48C), (Form 3468, Part III)

7. Generally those who receive the payment directly from the IRS equal to the applicable credit will treated as tax-exempt income.

a. For partners or shareholders in an S Corp. this will be allocated based upon their allocable share on the K-1.

b. With regards to partnerships and S corporations they cannot make an elective payment election with respect to the credit in association with the facility or property held directly by the partnership or the S corporation.

B. Making Elective Payment Election and Receiving Elective Payment

1. There are several steps to making a successful elective payment election. Not all steps need to occur in the order displayed below.

a. Identify and pursue the qualifying project or activity. You will need to know what applicable credit you intend to earn and use elective pay for. For more information about the applicable tax credits, see Q13.

b. Determine your tax year, if not already known. Your tax year will determine the due date for your tax return. Please see Q23 for information.

c. Satisfy all eligibility requirements for the tax credit and any applicable bonus credits, if applicable, for a given tax year. For example, to claim an energy credit on a solar energy generating project, you would need to place the project in service before making an elective payment election.

- You will need the documentation necessary to properly substantiate any underlying tax credit, including if bonus amounts increased the credit.

d. Complete pre-filing registration with the IRS. This will include providing information about yourself, which applicable credits you intend to earn, and each eligible project/property that will contribute to the applicable credit, among other information required. Upon completing this process, the IRS will provide you with a registration number for each applicable credit property. You will need to provide that registration number on your tax return as part of making the elective pay election.

- The applicable credit property should be placed in service prior to submitting a pre-filing registration.
- Complete pre-filing registration in sufficient time to have all of the valid registration numbers you need at the time you file your tax return.
- Please see Q32 through Q40 for more information about pre-filing registration

e. File the required annual tax return by the due date (or extended due date) and make a valid elective payment election. This includes properly completed and attached source credit forms, Form 3800, General Business Credit (or its successor), which should include registration number(s) and required return attachments.

2. The elective payment election is made on the annual tax return along with any forms required to claim the relevant credit. This may include Form 3800. It can apply to forms 1040, 1120, 1120 – S, 1065 and 990 – T.

3. The election once made is irrevocable and applies with respect to the credit for the tax year for which the election is made. For example, an applicable entity making the Clean Hydrogen Energy Credit would have the election in place for 10 years.

C. Transferability

1. Eligible taxpayers can transfer eligible credits. An eligible taxpayer is any taxpayer that is **not** an applicable entity under section 6417(d)(1)(A). The following entities are generally considered applicable entities and therefore are not eligible taxpayers and cannot transfer eligible credits: a tax-exempt organization, a state or political subdivision, a local government, an Indian tribal government, an Alaska Native Corporation, the Tennessee Valley Authority, a rural electric co-op, a U.S. territory, or an agency or instrumentality of a state, local, tribal, or territorial government.

2. Any eligible taxpayer that is not an applicable entity can elect to transfer (sell) all or a portion of the following "eligible credits."

- Energy Credit (48), (Form 3468, Part VI)
- Clean Electricity Investment Credit (48E), (Form 3468, Part V)
- Renewable Electricity Production Credit (45), (Form 8835, Part II)
- Clean Electricity Production Credit (45Y)
- Zero-emission Nuclear Power Production Credit (45U), (Form 7213, Part II)
- Advanced Manufacturing Production Credit (45X), (Form 7207)
- Clean Hydrogen Production Credit (45V), (Form 7210)
- Clean Fuel Production Credit (45Z)

- Carbon Oxide Sequestration Credit (45Q), (Form 8933)
- Credit for Alternative Fuel Vehicle Refueling/Recharging Property (30C), (Part 8911, Part II)
- Qualified Advanced Energy Project Credit (48C), (Form 3468, Part III)

D. Making Election to Transfer Eligible Credit

1. There are several steps for transferring eligible credits (or a portion of a credit). Not all steps need to occur in the order displayed below.

a. Pursue an eligible project. Identify and pursue a project that generates one of the eligible credits.

b. Satisfy all requirements necessary to earn the eligible credit for the tax year. For example, a solar energy project would need to be placed in service prior to earning an eligible credit.

- You will need the documentation necessary to properly substantiate any underlying tax credit, including if bonus amounts increased the credit.
-

c. Complete electronic pre-filing registration with the IRS. The online pre-filing registration process launched in December 2023. You may complete pre-filing registration as soon as you have all the information required, including the date the eligible credit property was placed in service. Pre-filing registration will include providing information about the eligible taxpayer, the intended eligible credit, and the eligible credit project. Upon completing this process, the IRS will provide a registration number for each eligible credit property.

- Complete pre-filing in sufficient time to have a valid registration number at the time you file your tax return.
-

d. Arrange to transfer an eligible tax credit to an unrelated party in exchange for only cash.

e. Provide the transferee (i.e., buyer) with the registration number, the required minimum documentation, and any other information necessary to claim the transferred eligible credit.

f. Complete a transfer election statement with the transferee (as described in Q6 below).

g. File a timely tax return and attach your transfer election statement. File a tax return for the taxable year in which the eligible tax credit is determined indicating the eligible credit has been transferred to a third party and include the transfer election statement and other information as required by guidance. The tax return must include the registration number for the relevant eligible credit property and must be filed no later than the due date (including extensions) for such tax return.

h. If applicable, renew pre-filing registrations and file returns for each subsequent year that a transfer election is made to transfer an eligible credit related to the eligible credit property.

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169**.**

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION V:

C CORPORATIONS

I. Tax Rate, AMT and Form 1120 Changes

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)).

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))

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 penalty 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.

E. Form 1120 Changes

1. Form 1120, Schedule J, Tax Computation and Payment, has had several lines added, expanding Line 1, Income tax, to seven lines, providing separate lines to accommodate entries flowing from specific forms to report additional tax or tax adjustments flowing from these forms.

2. The actual tax calculations has not changed but the details specifically listed on Schedule J have expanded. Additional lines have been added to Schedule J under lines 5, 9, 11, and 20 reporting more details referencing amounts flowing from other forms which previously may have been handled by attaching a schedule.

3. 2024 Form 4626, Alternative Minimum Tax- Corporations, Adds Schedule A, Pro-Rata Share of Adjusted Net Income or Loss of CFCs Described in Section 56A(c)(3).

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).

- 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: 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.

C. Form 7208: Excise Tax on Repurchase of Corporate Stock

1. Form 7208 is a new form for 2024 used to figure the excise tax on stock repurchase. The form is to be attached as well as any continuation sheets to Form 720: Quarterly Federal Excise Tax.

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)

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 $132,500 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. 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).

2. The surrender of stock by contributing shareholders to certain companies in proposed transactions were eight nontaxable contribution to the capital of the company's and the contributing shareholders did not recognize gain or loss on the contributions. Each contributing shareholders basis in the shares surrendered

would be allocated to the contributing shareholders basis in their remaining shares. The company receipt of the shares of stock from the contributing shareholders would not be taxable to the companies. Non-contributing shareholders did not recognize any income as a result of these transactions and the contributing shareholders surrender of shares would not be treated as a distribution of property to the noncontributing shareholders. (IRS Letter Rulings 202406001, 202406002, 202406005, 202406006, 202406007, 202406008, 202406009, 202406010, 202406011, 202406012, 202406013)

B. Corporate Reward Programs

1. Taxpayer who is a C corporation is required to include income 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 associated 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.

C. Global Intangible Low-Taxed Income (GILTI) – Section 951A

1. Section 951A was added to the code by the TCJA. A U.S. shareholder who owns stock of a foreign corporation on the last day of the foreign corporation's taxable year on which the foreign corporation is a controlled foreign corporation (CFC) includes in gross income its pro rata share of the CFC's subpart F income (for the taxable year (See Section 951(a)(1) and Reg. Sec. 1.951-1(a)).

2. In general, a U.S. shareholder's pro rata share of subpart F income is determined based on its proportionate share of a hypothetical distribution of all the current earnings and profits (E&P) and (current E&P) of the CFC (See Section 951(a)(2))

3. Use Form 8992 and its instructions to calculate the GILTI obligation.

D. Foreign Derived Intangible Income – Section 250

1. Section 250 was added to the Internal Revenue Code by the TCJA. The foreign-derived intangible income (FDII) deduction provides domestic C corporations a lower tax rate on income derived from tangible and intangible products and services in foreign markets.

2. Final regulations were issued in 2020 that provide guidance on deductions for FDII and GILTI allowed to domestic corporations,. including the computation of the deductions available and the determination of FDII.

3. Use Form 8993 and its instructions for the FDII deduction.

E. Section 351 Transfers

1. Section 351 (a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.

2. To the extent the transferor's receives taxable boot in the exchange, the transferee's have an increased basis in the assets received.

3. Section 351 does not apply to transfers involving foreign corporations.

Example

TBL Licensing LLC v. Comm., CA 1, 132AFTR 2nd 2023 – 5195. The Company transferred intangible property valued at $1.5 billion to an affiliate foreign corporation you was reported as a tax-deferred event related to a Section 351 exchange as part of a corporate reorganization. The company asserted the tax on the transfer the asset was eligible to be paid on an annual basis over time by one of the firm's affiliates. The IRS assessed the tax and denied the Section 351 transfer. The issue for the court is whether the reorganization transaction resulted in a disposal or disposition of an asset. Section 351 allows for deferred tax when assets are contributing to a corporation exchange for stock in the corporation and the transferee's are in control after the transfer require them to own at least 80% of the stock after the transfer. This transfer was associated with an asset transfer reorganization under Section 368. In that particular case the transfer corporation transfers all of the assets to the transferee corporation in exchange for some or all of the transferee's stock. Then the transferor distributes the acquired stock to shareholders and dissolves. Neither the transfer corporation nor the shareholders receive in the stock have a taxable event in the basis of the stock in the hands of the shareholders is equal to their basis in the transfer corporation which ceased to exist. However Section 351 only permits nonrecognition for corporations and holds that when a US person transfers property to a foreign corporation, the foreign corporation will not be considered a corporation for Section 351. The reorganization involved in foreign corporation does not qualify for nonrecognition treatment. Likewise, Section 367 holds that when he was person transfers property to a foreign corporation Section 351 cannot be considered.

F. Settlement Payments

1. Payments received by a corporation upon settlement of certain patent infringement litigation were includible in gross income or are nontaxable contributions to capital.

Example

Acqis Technology, Inc.v. Comm., TC Memo 2024 – 21. Payments received by corporation upon settlement of certain patent infringement litigation were includable in gross income or are nontaxable contributions to capital of the Corporation. The share purchase agreements executed with the taxpayers were viewed as sham transactions. Since the agreements were disregarded, the Tax Court examined the settlement and patent license agreements to determine the other party's intent for making the settlement payments to the taxpayer. The determination of the payors intent would dictate the tax consequences of the settlement payments to the taxpayer. The Court found no evidence that the other parties intended for the payments to buys shares or be served as capital contributions to the corporation. The other parties intended the settlement payment as damage to set off patent infringement litigation claims and to buy perpetual not exclusive licenses. Shares were not part of the issue. The income was viewed as to be includable in gross 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:

- 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

Gondal v. Comm., TC Memo 2024 – 36. Taxpayers failed to prove that cash withdrawals and personal expenses from their incorporated business were used for business purposes or treated as loans of which repayments had not occurred. As such the unreported income was viewed as a constructive dividend from the business to the owners/taxpayers.

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.

Maderia v. Comm., TC Summary 2024 – 5. The taxpayer received constructive dividends with the company paid for cell phone use, automobile expenses, car lease payments, iTunes bills, credit cards and other personal items. The taxpayer provided no evidence of the dispute.

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 specific expenses connected with the president and then show that the payments were of benefit to the president or corporate officer personally.

VIII. Corporate Reorganization – Section 355

A. Rule

1. The IRS has ruled on the tax consequence of a proposed corporate transaction involving a domestic parent and its subsidiaries within a multi national structure led by a foreign corporation. In this particular

case, subsidiary 1 wholly owned subsidiary 2 which operated a business directly through its disregarded entity. The IRS determined that the contribution of an intercompany receivable by Subsidiary 12 Subsidiary 2 and a distribution of Subsidiary 2's stock qualified as a reorganization under Section 355 and was viewed as a D reorganization. This resulted in no gain or loss be recognized by either Subsidiary 1 or the parent. The holding period of subsidiary 2 stock included the parents holding. (See IRS Letter Ruling 202445011)

IX. Selling Stock to ESOP

A. General Rule

1. Section 1042 provides a tax deferral opportunity for business owners considering selling their company to an Employee Stock Ownership Plan (ESOP). The primary advantages of Section 1042 is that it allows sellers to defer capital gains taxes on the sale of qualified securities domestic C corporation stock that is not privately traded.

2. After the sale, the ESOP or cooperative must own at least 30% of the company's stock. The seller must have held the securities for a minimum of three years prior to the.

3. It The seller must reinvest the proceeds from the sale into "qualified replacement property" within a specified time frame. This replacement period extends from three months before the sale to twelve months after.
4. Qualified replacement property (QRP) refers to securities issued by a domestic operating corporation and includes common stock, preferred stock, corporate bonds, and floating rate notes from qualifying US companies. There is no specific minimum holding period for QRP. The tax deferral continues until the taxpayer disposes of the QRP. Transfers via death and gift or divorce are not considered dispositions. An installment sale may not necessarily accelerate the recognition of any deferred gain.

Example

Berman v. Comm., 163 TC No. 1 (7/16/2024). The taxpayers each soul stock to an ESOP $44.15 million in which they had basis of $27,430 realizing a gain of well over $4.1 million each. As payment, each taxpayer received a promissory note of $4.1 million on which the first payment would be made in 2003. The taxpayers made elections under Section 1042 on their tax returns to deferred the recognition of the gain. To affect the deferral it required that the taxpayers purchase qualified replacement property at a cost equal to or exceeding the realized gain within 12 months of the sale of the stock. On their subsequent returns the reporting the acquisition of qualified replacement property with in the 12 month timeframe qualified them for deferral recognition of the $4.1 million gain. In the following year the taxpayers use the qualified replacement property as collateral for loans that equal to 90% of the property's value with the lender retaining 10% as a fee. The repayment terms of the loans were such that the Court consistently held that the loans were sales of property pledged as collateral. The 90% loan transactions in which they engaged in using the qualified replacement property constitutes a sale of that property triggering the bird gain to be recognized. A taxpayer sale of qualified replacement property triggers a recapture of the deferred gain this is accomplished through the imposition of a basis reduction whereby the taxpayer's basis in this property is reduced by the amount of the realized gain for which the recognition was deferred. The taxpayers contend that they disposed of their stock in installment sale and that they were entitled to recognize any gain on the sale under the installment method. The IRS argued that the qualified replacement property not only triggered the deferred gain but was an election out of the installment method. The court agreed with the taxpayer finding that the deferred gain claimed did not constitute electing out of the installment method on the original sale.

X. **Business Tax Account Expands to Include Corporate Designated Officials – Fact Sheet 2024 – 31 (124/1 to 4/2024)**

A. Background

1. The IRS announced the expansion of the Business Tax Account (BTA) to see corporations allowing Designated Officials (DO) to access the online self-service tool on behalf of the C Corporation.

2. The BTA allows businesses to manage tax-related tasks such as viewing balances, making payments, and accessing transcripts online. With the recent update, DOs can now view and pay their corporation's tax balances and make Federal Tax Deposits (FTDs).

3. Dos can use the Income Verification Express Service (IVES) to approve or reject a tax transcript authorization request from a lender. It also include tax returns, tax accounts, and entity transcripts for the current tax year and other past tax years. Some of the transcripts are now available in Spanish as well.

B. Designated Official (DO) Defined

1. A DO is someone legally authorized to bind the corporation and a current employee who received a Form W-2 for the latest tax filing year.
2. These officials gain full access to the corporation's tax information and can act on the business' behalf within BTA. Furthermore, a corporation can choose more than one person to represent them as long as they are one of these officials:

- President
- Vice President
- Chief Executive Officer (CEO)
- Chief Financial Officer (CFO)
- Chief Operating Officer (COO)
- Secretary
- Treasurer
- Limited Liability Company (LLC) Managing Member

C. Registration

1. DO's will need to do the following to register:

a. Collect all required documents. Collect tax records, including the corporation's Employer Identification Number (EIN), its latest federal tax return (Form 1120 or 1120-S), and the IRS-registered mailing address.
b. Sign into the corporation's existing BTA. Ensure that the corporation has an active account to proceed with registration.
c. Request a PIN. A PIN is a unique, non-transferable PIN that is assigned to the DO when they register. The IRS will mail this PIN to the corporation's most recent business address within five to 10 business days.

2. DOs are required to validate their access to the business' tax information annually through the BTA.

3. The IRS recommends that corporations assign multiple DOs to ensure continued access. However this is optional and is not a requirement.

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169**.**

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION VI:

S CORPORATIONS

I. Form 1120 – S Changes

A. Schedule K and K-1

1. There has been a change in some of the reporting codes particularly with respect to lines 13g and 17g. The following codes have been added:

Code S. Unused investment credit from clean electricity credit allocated from cooperatives.
Code W. Clean electricity production credit.
Code X. Clean fuel production credit.
Code AV. Clean electricity investment property

II. 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.

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.

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.

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.

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.

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.

III. 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. 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 Asset 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.

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.

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.

IV. 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.

- **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.
- **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.

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.

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. 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).

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.

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:

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

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 120 days of the date of the Private Letter Ruling. (PLR 202322011)

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)

V. 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. 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:

> *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.

VI. 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.

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.

VII. 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
- At 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.

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:

	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

4. A shareholder's stock basis is **decreased**, but not below zero, the following:

	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

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.).

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.

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.
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)).

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.

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.

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.

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.

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.

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.

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))

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. 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.

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.

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.

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:

- 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

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.

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.

VIII. 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.

IX. 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:

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

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;

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. Final 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.

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).

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.
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.

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.

C. Treatment of a redemption made during an S corporation's post-termination transition period - Rev. Rul. 2019-13, 2019-20 IRB

1. The Service has ruled on the treatment of a distribution in redemption of a shareholder stock, that is made during a former S corporation's post-termination transition period.
2. When an S corporation's S status terminates, it goes through a "post-termination transition period" (PTTP) under Section 1377 (b) (1). During the PTTP, the former S corporation can continue to take advantage of some of the benefits associated with its S status. For example, Section 1371 (c) provides that, in general, any distribution of cash by a former S corporation with respect to its stock during the PTTP is applied against and reduces the adjusted basis of the stock to the extent the distribution does not exceed the corporation's AAA.

3. Section 302 (a) sets conditions for distributions in redemption of stock of a corporate shareholder being treated as distributions in payment in exchange for the stock. Where those conditions are not met, such distributions are treated as distributions of property to which Section 301 applies. It sets out rules for the treatment of such distributions, including treatment of the distributions as dividends and as amounts applied against basis.

Example

X is an entity that once was a C corporation and later elected to be an S corporation. X's S election terminated, such that it is now a C corporation. A, an individual, owns all 100 shares of the outstanding stock of X. X is a calendar-year taxpayer. At the time of its conversion to an S corporation, X had accumulated earnings and profits (E&P) of $600x and no current E&P. At the time of the termination of its S election, X's AAA was $800x and its accumulated E&P was still $600x. During X's PTTP, X redeems 50 of A's 100 shares of X stock for $1,000x. X makes no other distributions during the post-termination transition period. Pursuant to Section 302(d) of the Code, the redemption is characterized as a distribution subject to Section 301. For the taxable period that includes the redemption, X has current E&P of $400x.

4. The Revenue Ruling provides that the corporation should reduce its AAA to the extent of the proceeds of the redemption pursuant to Section 1368.

X. 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.

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.

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.*

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.

XI. QSST v. ESBT

A. General

1. Only certain types of trusts are permitted to hold an interest in an S corporation. Two of these are an electing small business trust, or ESBT, and a qualified Subchapter S trust, or QSST.

B. ESBT

1. To qualify as an ESBT, the permissible beneficiaries of the trust generally are limited to individuals, estates, and charitable entities. Certain government entities also may qualify as permissible beneficiaries but only if the entity holds a contingent interest in the ESBT. (See Section 1361(e)). A trust is precluded from qualifying as an ESBT if any interest in the trust has been acquired by purchase (See Section 1361(e)(1)(A)(ii)).
2. A trustee may elect to treat a trust as an ESBT. The ESBT election generally must be filed within two months and 16 days of the date the S corporation stock is transferred to the trust. However, if the trust holds C corporation stock and the corporation makes an S election that is to be effective as of the first day of the tax year in which it is made, the ESBT election must be made within two months and 16 days of the date the S election is effective (See Regs. Secs. 1.1361-1(m)(2)(iii) and 1.1361-1(j)(6)(iii)). Regardless of the number of S corporations whose stock is owned by the ESBT, only one election is required (unless the S corporations file at different service centers).

3. An ESBT is bifurcated into an S portion and a non-S portion (Regs. Sec. 1.641(c)-1(a)). Income attributable to the S portion of the ESBT is taxed to the trust and is subject to tax on its ordinary income at the highest marginal rate applicable to trusts and net capital gains at the maximum capital gains rate.

4.To the extent that one portion of an ESBT is deemed to be owned by a grantor, the grantor trust rules apply; in that case, it is permissible for a partial grantor trust to file an ESBT election, but the grantor portion will be taxed under the rules generally applicable to grantor trusts and not as part of the S portion. If a nonresident alien is a potential current beneficiary, the grantor trust rules do not apply, and the trust is taxed under the regular ESBT rules.

5. QSSTs, tax-exempt trusts, and charitable remainder trusts are ineligible to be treated as ESBTs (See Section. 1361(e)(1)(B)). For purposes of the 100-shareholder limitation applicable to S corporations, each potential current beneficiary of an ESBT is treated as a shareholder. Under the Tax Cuts and Jobs Act, P.L. 115-97, nonresident aliens are permissible beneficiaries of an ESBT and will not impair the EBST's eligibility as an S corporation shareholder.

6. Under Sec. 678, if the beneficiaries of an ESBT are granted the sole power to withdraw the S corporation income that is distributed to the trust annually, they are taxed on this trust income at their own tax rates regardless of whether they withdraw it. An ESBT itself is not taxed on the income of the trust attributable to the S corporation to the extent the beneficiaries are taxed under Sec. 678.

a. Note that under Section 678, a person other than the grantor is treated as the owner of any portion of a trust over which the person:

- Has a power (exercisable solely by himself or herself) to vest the corpus or the income from the trust in himself or herself; or
- Has previously partially released or otherwise modified such a power and subsequently retains control of the trust that under the grantor trust rules would cause the grantor to be treated as the trust's owner.

7. Under Sec. 678, it may be impossible in certain situations to cause all the taxable income allocable to an ESBT's interest in the S corporation to be taxed to the trust's beneficiaries. It is, of course, impossible for income (including taxable income) not actually distributed by the S corporation to the trust (i.e., in the way of dividends) to be withdrawable by the trust's beneficiaries. Thus, only the ordinary income of the S corporation portion of an ESBT is withdrawable.

8. If a portion of the taxable income of the S corporation is not distributed to the ESBT (i.e., as a result of working capital or other needs), and in effect is therefore allocable to trust corpus, this retained taxable income of the S corporation will be taxed to the ESBT at the highest federal income tax rate. If the client's family controls the S corporation, one possible workaround to this situation would be for the S corporation to first distribute this portion of the income to the ESBT and then have the trustee of the ESBT voluntarily invest the same back into the corporation.

.

a. The Service has finalized regulations that ensure that the income of an S corporation will continue to be subject to U.S. income tax when a nonresident alien is a deemed owner of a grantor trust that elects to be an electing small business trust (ESBT). The final regulations adopt, without any changes, proposed regulations that were issued in April, 2019.

b. Prior to the enactment of the Tax Cuts and Jobs Act, a change in the immigration status of a potential current beneficiary (PCB) of an ESBT that owns S corporation stock from resident alien to NRA would have terminated an ESBT election, and therefore also terminated the corporation's election as an S corporation.

c. Section 13541(a) of the TCJA amended Section 1361(c)(2)(B)(v) to provide that the rule treating each PCB of an ESBT as a shareholder does not apply for purposes of the eligible-shareholder requirement of S status. As a result of that TCJA amendment, if a resident alien PCB of an ESBT becomes a nonresident alien, the status of that PCB as a nonresident alien will not cause the S corporation of which the ESBT is a shareholder to fail and terminate its S election.

d. The Service has issued final regulations that are unchanged from the proposed regulations.

e. The regulations ensure that, with respect to situations in which a nonresident alien is a deemed owner of a grantor trust that has elected to be an ESBT, the S corporation income of the ESBT continues to be subject to U.S. Federal income tax.

f. Specifically, the regulations modify the allocation rules under Reg. §1.641(c)-1 to require that the S corporation income of the ESBT be included in the S portion of the ESBT if that income otherwise would have been allocated to a nonresident alien deemed owner under the grantor trust rules. (Reg §1.641(c)-1(b)(1)(ii))

g .The regulations apply to all ESBTs after December 31, 2017. (Reg §1.641(c)-1(k); Reg § 1.1361-1(m)(9))

C. QSST

1. A QSST is a trust with a single income beneficiary who makes an election to be treated as the deemed owner (See Section 1361(d)(3)).

2. The Code generally applies the grantor trust rules to a duly formed QSST, in which the current income beneficiary is treated as the shareholder.

3. Upon disposition of the S corporation stock by the QSST, the trust will be treated as the owner, and any gain or loss recognized on the disposition will belong to the trust and not to the income beneficiary (See Regs. Sec. 1.1361-1(j)(8)).

4 .A QSST cannot distribute any portion of the trust corpus to anyone other than the current income beneficiary during the beneficiary's lifetime. All current trust accounting income must be distributed annually to the current income beneficiary.

5. The income interest of the current income beneficiary ceases upon the earlier of the beneficiary's death or the termination of the QSST. Should the QSST terminate during the life of the current income beneficiary, all the QSST assets must be distributed to the beneficiary. The income beneficiary (rather than the trustee) of the trust makes the QSST election. *Separate* elections are required for each S corporation whose stock is held by the trust.

6. Compared to ESBTs, QSSTs generally have significant disadvantages which include the following:

- There can be only one lifetime beneficiary of a QSST, meaning that the beneficiary's children cannot also be beneficiaries of the trust, which is not the case for an ESBT.
- All the ordinary income of a QSST must be distributed to the beneficiary currently, regardless of need, thus causing potentially unnecessary buildup of the QSST beneficiary's taxable estate by the compounded value of the QSST's share of the S corporation's distributed income.
- There are nontax x issues with this type of trust as well including the exposure of the compound value of the trust share lawsuits against the Q SST beneficiary such as marital rights to potential income in the divorce, creditor attachment and access to income for under age individual for example.

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169.

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION VII:

PARTNERSHIP AND LLC ISSUES

I. Form 1065 Updates

A. Schedule B

1. Question 29 asked whether a partnership is required to file 7208 relating to the excise tax on the repurchase of corporate stock

2. A new question 32 has been added regarding entities that elect out of Subchapter K. The previous question number 31 has been renumbered to number 33.

B. Schedules K and K – 1 Line 15 Credits

1. The following codes have been activated for line 15:

- S, Unused investment credit from the clean electricity investment credit allocated from
- cooperatives; code
- W, Clean electricity production credit; and
- X, Clean fuel production credit.
- AN was set to reserve for future use.
- ZZ, is associated with a partnership that is made an election to transfer a portion of all of their credit to other individuals.

2. Line 19, Code C Other Property. This has been updated to clarify information partners May need when filing Form 7217: Partnership Report of Property Distributed by a Partnership.

3. Line 20: Other Information Codes AZ the associated with Clean Electricity Investment Property and Code AX, assist with corporate alternative minimum tax have been added.

4. Schedule K – 1, Box 13 Other Deductions. Has been updated with respect to qualified conservation contributions and Box 15 Credits, if the partnership has made an election to transfer portion or all of the credits to other parties that must be reflected in that box.

C. Schedules K – 2 and K – 3

1. Part IX, Section 2, Line 7. Cost-sharing transaction payments are now separately reported. On line 17 and 18 column (c) has been clarified to include amounts subject to tax at a 30% withholding statutory rate.

2. Part XII has been added provide information regarding a partnership that is or has one or more branches that are qualified derivative dealers.

3. Schedule K – 3, Part XIII, Line 8. Gain that would be recognized on the deemed sale of un-recaptured section 1250 gain has been removed. Since this type of gain results in the conduct of US trade or business, the partnership should include the gain on line 5 as aggregated effectively connected gain recognized on the deemed sales rules in association with un-recaptured section 1250 gain assets.

4. Exceptions to Filing Schedules K – 2 and K – 3. There is a domestic filing exception that allows an exception from filing and furnishing the schedules for 2024. Four criteria must be met:

a. Limited or no foreign activity. The entity had $300 or less in foreign income tax, paid or accrued, and the foreign income tax is reported on a US information statement such as 1099-INT, 1099-DIV, 1099-B, or K-1.)

b. U.S. citizen/resident alien owners. Partners and shareholders are:

- Individuals that are U.S. citizens,
- Individuals that are resident aliens,
- Domestic decedents' estates,
- Domestic grantor trusts with solely U.S. citizen and/or resident alien individual beneficiaries,
- Domestic non-grantor trusts with solely U.S. citizen and/or resident alien individual beneficiaries,
- S corporations with a sole shareholder, and
- Single member limited liability companies with the sole member as described in any of the above.

c. **Owner notification**. The exception includes a requirement that the partnership or S corporation must notify its partners or shareholders that no Schedule K-3 information will be provided (unless requested). Valid partner or shareholder notifications may be made up to the due date for filing, including extensions. Partner and shareholder notifications may be provided to the partners and shareholders as a statement included with their timely issued K-1s.

d. . No requests by one-month date. Partners and shareholders have until one month prior to the return filing date, to timely request Schedule K-3. If a timely request is made, Schedules K-2 and K-3 must be completed and filed with the federal pass-through entity tax return and provided to the requesting partner or shareholder. If a partner or shareholder requests Schedule K-3 after the one-month window, Schedule K-3 must be provided to the partner or shareholder within 30 days, but Schedule K-2 and any applicable Schedule K-3s are not required to be filed with the entity tax return.

D. 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.

E. 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.

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.

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."

F. Form 1065 – X

1. Form 1065 – X was revised December, 2024. Under the revisions part I, section 2 – BBA AAR Item C Two was added to indicate when the adjustment does not result in an imputed underpayment.

2. Part II, line 13 was changed from contributions to Cash Contributions and line 13 b was changed to indicate non-cash contributions.

G. IRS Releases Draft Form 7217: Partners Report of Property Distributed by a Partnership

1. The IRS requested public comments on draft Form 7217, Partner’s Report of Property Distributed by a Partnership, and instructions for draft Form 7217 today.

2. The purpose of Form 7217 is to report all distribution of property that a partner receives from a partnership.

3. A partner receiving a distribution of property from a partnership in a nonliquidating or liquidating distribution will use the form to report the basis of the distributed property. The form is not to be used with respect to disguised sales.

4. The IRS also posted draft instructions on September 3, 2024. The instructions state that any partner receiving a property distribution from a partnership must file Form 7217, regardless of whether there is a basis adjustment in the hands of the partner as a result of the distribution.

5. Form 7217 is not filed for distributions that consist of only money or marketable securities treated as money.

6. The information from Form 7217 does translate to box 19, code C on the K-1.

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. The taxpayer acquired an interest in an upper tier to partnership for $100,000. As part of the transaction, the taxpayer provided advisory services aimed at improving the performance of the business assets held by the lower tier partnership and finding buyers for the upper tier partnership interest. The taxpayer contended that the interest in the upper tier partnership constitutes a profit interest which is typically considered a nontaxable event when granted. The IRS argued that the interest was not a profit interest but a capital interest primarily because services were provided to the upper tier partnership when it was a disregarded entity and not directly as a partnership. The court rejected the IRS's argument characterizing the upper tier partnership as a mere conduit through which the taxpayer provide services to or for the benefit of others specifically the limited partnership. The language in the operating agreement ensures the taxpayers rights are identical to the interest in the limited partnership. The IRS argued the taxpayer was entitled to a share of liquidation proceeds upon receiving the interest supported by its own valuation and experts. The tax court rejected the IRS's argument and rely on implied valuation derived from the sale of 70% of the business to 1/3 party investor. The taxpayer had no entitlement to any liquidation proceeds at the date of receiving their interest in the upper tier partnership due to the language in the operating agreement which prioritize distribution to other partners before profit interest holders.

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

Surk LLC v. Comm., TC Memo 2024 – 99. A partnership under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), was liable to decrease its yearend outside basis by the excess losses as determined by the IRS in the Notice of Final Partnership Administrative Adjustment (FPAA). The taxpayer, in tax years prior to the tax year at issue, had improperly deducted passthrough losses from a lower tier TEFRA partnership (P2) that were in excess of its outside basis in P2 in violation of the loss limitation rule of Section 704(d). The IRS determined that the taxpayer must decrease its outside basis in P2 for the tax year at issue to account for the excess losses. The Tax Court noted the taxpayer had sufficient outside basis to deduct the entire P2 loss. The IRS did not disallow the deductions in the previous tax years, and those years were now closed. In such an instance, the returns provided the final tax treatment, and the taxpayer was bound by the reporting on the returns. The taxpayer conceded that it had improperly deducted the excess losses for the previous tax years. The taxpayer now sought to disregard its own reporting to claim future tax benefits. Additionally, if the taxpayer would not have been required to decrease its outside basis by the previously allowed excess losses, its outside basis would have been overstated and would have permitted loss deductions in excess of the taxpayer's investment in its P2 partnership interest. Accordingly, under Section 704(d) the taxpayer was liable to decrease its outside basis in P2 by all previously allowed losses.

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. 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.

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.

3. The Tax Cuts and Jobs Act modifies the basis limitation on partners losses to provide that the limitation takes into account the partner's distributive share of partnership charitable contributions. The amount of the basis limitation on partners losses is decreased to reflect the charitable contribution. In the case of a charitable contribution made by the partnership, the amount of the basis limitation on partners losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. In the case of

a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a special rule applies. The basis limitation on the partners losses does not apply to the extent of the partner's distributive share of the excess.

Example

AB partnership contributes stock to a charitable organization. The basis in the stock is $20,000 and its fair market value is $50,000. Each partner's basis limitation on the loss is reduced by $10,000 rather than $25,000.

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. 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.

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:

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.

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.
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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.

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).

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.

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).

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.

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

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.

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.

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.

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.

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.

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.

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)

Example

Piccirc LLC v. Comm., TC Memo 2024 – 50. In a case involving the tax treatment of a structured distress debt investment transaction which involved transfers of distressed foreign trade receivables through various domestic partnerships, the IRS determined that losses should be disallowed. The taxpayer reported the losses as ordinary losses. The purported loss was allocated to another LLC. The transaction was deemed to be a disguised sale because the partnership's transfer of money or other consideration to the partner would not have been made but for the partner's transfer of property and if the transfers were not made simultaneously, the transfer was not dependent on entrepreneurial risk of the partnership's operations. The payment to another LLC was not paid out of operational profits but rather from the proceeds of the partner's subsequent acquisition of an interest in an LLC. The taxpayer failed their burden of proof and the transaction was deemed a disguised sale.

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 $100 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 $100 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.

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.

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:

- 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.

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.

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:
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.

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.

a. The idea behind basis shifting is to remove tax basis from certain assets and move them to other assets to lower taxes. In essence, the shifting increases depreciation deductions or reduces gain on sale of an asset with little or no substantiative economic effect. Often this technique is used in related party transactions.

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.

b. The transactions were identified as transactions of interest. A transaction of interest is a transaction that the IRS believes has the potential for tax avoidance or tax evasion. More specifically, it involves transactions with a positive basis adjustment of $5 million or more. In determining the $5 million threshold, positive basis adjustments are reduced by any gain recognized on the transaction.

4. The transactions heightened scrutiny involves the distribution of partnership property to a partner that is related to one or more other partners in the partnership and the transfer of a partnership interest when the transferor is related to the transferee or one or more of the partners.

5. Specifically, the economic substance doctrine will be raised in cases where related parties:

- Create inside/outside basis disparities through various methods, including the use of certain partnership allocations and distributions,

- Capitalize on the disparity by either transferring a partnership interest in a nonrecognition

transaction or making a current or liquidating distribution of partnership property to a partner, and
- Claim a basis adjustment under Sections 732(b) or (d), 734(b) or §43(b) resulting from the nonrecognition transaction or distribution.

a. Partners who engage in these transactions as well as their material advisors must disclose them to the IRS on Form 8886: Reportable Transaction Disclosure Statement and advisors must use Form 8918: Material Advisor Disclosure Statement. The disclosures must be filed with the return for the year the transaction occurred.

b. A material advisor is a person who provides material aid, assistance, or advice with respect to reportable transaction and who directly or indirectly to rise gross income exceeding $50,000 in a single year or $250,000 if reportable transaction is related to a corporation from such advice or assistance..

5. As indicated, the Revenue Ruling discusses three examples associate with basis shifting all of which would be transactions of interest and thus reportable on Form 8886:

Examples

Partnership Property Transferred. ABC partnership holds an asset with a fair market value of $300,000 and adjusted basis of $100,000. The partnership has three equal partners A, B and C. The partnership distributes the asset to A who has a basis in their partnership interest of $50,000. A's basis in the property distributed would be limited to the $50,000 and the partnership's basis in the asset ($100,000) would exceed the basis taken by A. The excess basis of $50,000 would be allocated among the partnership's remaining assets which could potentially lower taxes for the remaining partners B and C. This is viewed as a transaction of interest and would be reportable.

Partners A and B each own 50% of Partnership A B. A has a basis of $200,000 in his partnership interest. The partnership's assets have a total inside basis of $300,000. A sales his entire interest to C, a party related to B for $500,000. C takes a basis of $500,000 in the acquired partnership interest. If a Section 754 election is in effect, the partnership would be entitled to a step up in basis in the assets of $300,000. This represents the difference between C's outside basis and his share of the Partnership's inside basis. The basis step up could generate additional depreciation or reduced gain on a future sale of assets lowering taxes to the remaining partners.

The revenue ruling then analyzes economic substance doctrine case law and concludes that the changes

6. 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.

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.

VII. Regulations for Determining a Partners Distributive Share involving Varied Interest – Section 706, Reg. 1.706 – 4

A. Rule

1. The Service has issued final regulations on determining a partner's distributive share of partnership items when the partner's interest changes during the tax year and on rule changes impacting the required Tax Year of a partnership. These final regulations apply for such transactions occurring on or after August 3, 2015. They also apply to publicly traded partnerships formed prior to April 19, 2009.

2. A partnership taxable year shall close with respect to a partner who sells or exchanges his or her entire interest in the partnership. This can also apply with respect to a partner whose entire interest in the partnership is liquidated or who otherwise dies.

3. In the case of death, liquidation, sale or exchange of a partner's entire interest in the partnership, the partner shall include in his or her taxable income for said tax year there distributive share of separately stated items in any guarantee payments for a partnership year ending in the year or date of termination.

4. If a deceased partner's estate per successor sells or exchanges that deceased partner's entire interest the partnership or such interest is liquidated, the partnership taxable year with respect to said estate per successor interest shall close on the date such sale or exchange occurs or the date of the liquidation being completed.

Example

Bubba is a partner in a partnership with a December 31 year-end. He files a joint tax return. Bubba dies on March 31, 2024. The administration and probate of his estate is completed and the partnership interest is distributed to his wife on November 30, 2024. That distribution to the wife is not a sale or exchange of Bubba's partnership interest. The taxable year of the partnership will close with respect to Bubba on March 31, 2024. Bubba will include in his final return for his final tax year is distributive share of partnership items for the timeframe January 1, 2024 through March 31, 2024. His wife will include on her return her distributable share of items of the partnership from April 1, 2024 through December 31, 2024.

5. The final regulations provide rules for determining the partner's distributive shares of partnership items when the partner's interest in the partnership varies during the tax year. A variable interest can occur with respect to a disposition of a partial or complete interest in the partnership or it can occur with the admission of a new partner for example.

6. Once the segments are determined, the allocation the very interest can occur under one of 3 methods that can be chosen by the partnership:

- A calendar day approach where each variation is deemed to occur at the end of the day on which the variation occurs.
- A semimonthly approach, where a variation occurring on the first to the 15th day of a calendar month can be utilized at the end of the last day of the immediately preceding calendar month or in the case of a variation occurring on the 16th day to the last day in the calendar month, at the end of the 15th day of that month.
- A monthly approach, where if a variation occurs on the first to the 15th day of a calendar month, the allocation will be deemed to be occurring on the last day of the immediately preceding calendar month or if the variation occurs the 16th day to the last day calendar month at the end of the last day of that month.

7. As a general, a partnership generally will use the calendar day method for each variation. The date or beginning date for calendar year cannot be before January 1. For fiscal years it's the beginning date of the fiscal year. A publicly traded partnership that is deemed to be a partnership may apply any of the above methods.

8. Extraordinary items are not to be prorated. Rather, they are allocated to the partners in proportion to their interest in the partnership at the time of day on which the extraordinary item occurred regardless of the method of allocation. Extraordinary items can still be subject to special limitations or requirements as stated in the partnership agreement.

9. An extraordinary item consists of the following:

- Any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset (determined without the application of any other rules of law);
- Any item from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or business as defined in §1231(b) (determined without the application of any holding period requirement);
- Any item from the disposition or abandonment of stock in trade, property used in a trade or business subject to depreciation, or accounts receivable if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions);
- Any item from assets disposed of in an applicable asset acquisition under §1060(c);103•Any item resulting from any change in accounting method initiated by the filing of the appropriate form after a variation occurs;
- Any item from the discharge or retirement of indebtedness (except items subject to §108(e)(8) or §108(i), which are subject to special allocation rules provided in §108(e)(8) and §108(i));
- Any item from the settlement of a tort or similar third-party liability or payment of a judgment;106•Any credit, to the extent it arises from activities or items that are not ratably allocated (for example, the rehabilitation credit under §47, which is based on placement in service);

- For all partnerships, any additional item if, the partners agree to consistently treat such item as an extraordinary item for that taxable year; however, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner's return; any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for §179 expenses);
- Any item which, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included;
- Any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin.

10. A partnership may treat an item considered extraordinary as other than extraordinary if the total of all the items in that particular class is less than 5% of the partnership's gross income including tax-exempt income.

10. It appears that the partners can have a written agreement in place on selecting the method of allocation. Partnership agreements may need to be looked at for amendment for such purposes. This agreement or amendment of the partnership agreement is not required but highly suggested.

11. The regulations provide that with respect to any taxable year in which there is a change in a partner's interest in a partnership for which the capital is not material income producing or is not a material income producing factor, the partnership and the partner can choose to determine the partner's distributive share of income, gain, loss, deduction and credits using any reasonable method available. This does not apply to transfers of interest in connection with the performance of services.

VIII. Recourse Debt – Section 752; Treasury Regulations 1.752 – 2

A. Rules

1. The Service has issued final regulations with regards to recourse and nonrecourse debt. In determining a partner's share of recourse debt, the amount of partnership debt taken into account is determined only once. If the aggregate amount of the economic risk of loss that all partners bear with respect to liabilities of the partnership exceed the amount of the liability, economic risk of loss is attributable to each partner with respect to the debt equaling the amount determined as follows:

$$\text{Amount of Liability} \times \frac{\text{Amount of economic risk each partner bear}}{\text{Total economic risk of loss borne by partners}}$$

Example

Able and Baker are unrelated parties but equal members in a partnership. The partnership borrows $1000 from Bad Bank. Able personally guarantees the entire amount. The bank requires Baker to guarantee as well but not the entire amount only $500. Both parties waive their rights of contribution from each other under the partnership agreement. The total economic risk of loss is $1500. The total economic risk of loss being $1500 exceeds the partnership liability of $1000. The economic risk of loss is determined as follows:

Able = $1000 X $1000/$1500 = $667
Baker = $1000 X $500/$1500 = $333

2. A partner bears the economic risk of loss for partnership liability to the extent that if the partnership liquidated, the partner will be obligated to make a payment to any person or a contribution to the

partnership because that liability became due and payable and the partner would not be entitled to reimbursement from another person. (See Treas Reg. 1.752 – 2 (b)(1))

3. The determination of the extent to which a partner has an obligation to make a payment is a fact and circumstance examination.

4. A payment obligation will not be deemed to be considered recourse debt if:

- Contractual obligations outside the partnership agreement such as personal guarantees, indemnifications reimbursement agreements run directly to creditors, other partners or the partnership.
- Obligation to the partnership imposed by the partnership agreement include obligations to make a capital contribution and restore a deficit capital account upon liquidation. This does not create partnership debt or recourse debt.
- Payment obligations imposed by state law are not considered recourse debt nor created economic risk of loss that would subsequently increase basis.

Example

Abel and Baker for a limited partnership. Able is the general partner and contributes $2000. Baker is the limited partner and contributes $8000 of cash. The partnership agreement allocates 20% to Able and 80% to Baker until Baker's capital account is reduced to zero. After that time all losses are allocated to Baker. The partnership purchases depreciable property for $25,000. At the time purchase it pays $10,000 cash and incurs a loan note of $15,000. Baker personally guarantees the note of $15,000. The guarantee requires the bank to go after the partnership first and exhaust its remedies before going after Baker. As such under these proposed rules it would be considered a constructive liquidation. The $15,000 debt would become due and payable. Under the hypothetical, all partnership assets are deemed worthless. Hence, the property would be sold for a zero value and the capital accounts would be adjusted to reflect the hypothetical loss on the disposition as follows:

	Able	**Baker**
Contribution	$2,000	$8,000
Hypothetical Sale	($17,000)	($8,000)
Ending Capital Account	($15,000)	

Able as s general partner will be obligated to make a net contribution of $15,000. Since Abel is assumed to have net value to satisfy the obligation, Baker would not have to satisfy the guarantee. The loan is treated as recourse debt because one or more the partner's board the economic risk of loss. As such, enables share of the recourse debt is $15,000 and Baker's is zero.

Example

Bryan v. Comm., TC Memo 2023 – 74. The Tax Court held that a taxpayer improperly deducted passthrough losses from tiered partnerships the taxpayer formed to produce movies after finding that loans made to the lower-tier partnerships from an upper-tier partnership did not increase the taxpayer's outside basis under Section 752 because neither the taxpayer nor the upper-tier partnership bore any economic risk of loss as to the liabilities. The court further found that the taxpayer failed to meet the Section 465 at-risk requirement with respect to a lower-tier partnership's movie-making activity to deduct the upper-tier partnership's losses.

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. Once a Section 754 election is made it applies to all distributions of property other than cash and to all transfers such as a sale of a partnership interest made during the tax year and in all subsequent years unless the election is revoked.

4. Under the election a partnership may elect to adjust the basis of partnership property, Subchapter K allows for basis adjustment with the election when inside and outside basis differrence could occur two ways:

a. Section 734 (b) on a distribution of assets. A partner who receives property (other than cash) in exchange for liquidating his partnership interest will not recognize gain or loss on the liquidation of that interest. The partner's basis in the property received will be the basis in their partnership interest. The difference between the partnership's basis in the assets distributed and the partner's basis in their partnership interest is the amount of the Section 734(b) adjustment. The adjustment can be positive or negative. The basis of the remaining partnership assets will be adjusted by the positive or negative §743(b) adjustment. This adjustment is allocated to all of the remaining partners.

b. Section 743 (b) transfer of a partnership interest. The new partner gets an outside tax basis in the partnership equal to the purchase price of the partnership interest (or fair market value of the partnership interest if an inheritance). With respect to inside basis in partnership assets, the new partner "steps into the shoes" of the transferor partner and is allocated his proportionate share of basis in the partnership assets. A Section 743 basis adjustment is made to the partnership's basis in the assets so that the transferee (new) partner's inside basis is equal to their outside basis. This adjustment to the basis of the assets is only allocated to the new partner for allocations such as depreciation and amortization.

5. 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.

D. Section 754 Elections and Form 1065 Schedule B Other Information

1. Section 754 elections cause additional reporting on the partnership tax return. Below are the Form 1065 lines requiring additional information and the applicable instructions.

a. Line 10a: Is the partnership making or had it previously made (and not revoked), a §754 election? If "Yes." enter the effective date of the election.

b. Line 10b: For this year, did the partnership make an optional basis adjustment under §743(b)? If the partnership answers "Yes," it will need to provide the total aggregate net positive and total aggregate net negative amounts for the §743(b) adjustments for all partners made during the year and attach a statement showing the computation of each such adjustment.

c. Line 10b instructions. Answer "Yes" if either of the following has occurred.

• The partnership made an optional basis adjustment under §743(b) or §734(b) for the tax year.

• The partnership has made a §754 election (and it hasn't been revoked) and a basis adjustment under §743(b) is made on a sale or exchange of a partnership interest or a transfer of a partnership interest on the death of a partner. See question 10c if the partnership has a substantial built-in loss immediately after such a transfer.

d. Aggregate net positive amount means the increase in the partners' share of basis in partnership property from all §743(b) adjustments allocated to all the partners. "Aggregate net negative amount" means decrease in the partners' share of basis in partnership property from all §743(b) adjustments allocated to all the partners.

e. Section 743(b) basis adjustment statement. The basis adjustment affects only the transferee's (new partner's) basis in partnership property. The partnership must attach a statement to the return for the tax year in which the transfer occurred. The statement must include:

- The name of the transferee partner,
- The EIN or SSN of the transferee partner,
- The computation of the adjustment, and

- The identity of the partnership properties to which the adjustment has been allocated.

f. Line 10c: For this year, did the partnership make an optional basis adjustment under §734(b)? If the partnership answers "Yes," it will need to provide the total aggregate net positive and total aggregate net negative amounts for the §734(b) adjustments for all partners made during the year and attach a statement showing the computation of each such adjustment.

g. Line 10c instructions. If the partnership has made a §754 election (and it hasn't been revoked), the partnership must make a basis adjustment under §734(b). "Aggregate net positive amount" means the increase in the basis of partnership property from all §734(b) adjustments. "Aggregate net negative amount" means the decrease in basis of partnership property from all §734(b) adjustments.

h. Section 734(b) basis adjustment statement. For a §734(b) basis adjustment, attach a statement that includes:

• The computation of the adjustment,
• The class of property distributed (ordinary income property or capital gain property), and
• The partnership properties to which the adjustment has been allocated.

i. Line 10d: For this tax year, is the partnership required to adjust the basis of partnership property under §743(b) or §734(b) because of a substantial built-in loss (as defined under §743(d)) or a substantial basis reduction (as defined under §734(d))? If the partnership answers "Yes," it will have to enter the total aggregate amount of §743(b) adjustments and/or §734(b) adjustments for all partners and/or partnership property made for the tax year and attach a statement showing the computation and allocation of each basis adjustment.

j. Line 10d instructions. Answer "Yes" if the partnership had to make a basis reduction under §743(b) because of a substantial built-in loss (as defined in §743(d)) or under §734(b) because of a substantial basis reduction (as defined in §734(d)). The adjustment amount provided should be a positive number. A substantial basis reduction under §734(d) and substantial built-in loss under §743(d) exists when there basis adjustments required by a §754 election exceed $250,000 for either §734 or §743.

k. Section 734(b) basis adjustment statement. For a §734(b) basis adjustment, for partnerships other than PTPs, attach a statement that includes:

• The computation of the adjustment,
• The class of property distributed (ordinary income property or capital gain property), and
• The partnership properties to which the adjustment has been allocated.

2. Schedule K – 1 Reporting. If the basis of partnership property has been adjusted for a transferee partner, the partnership must adjust the transferee's distributive share of the items of income, deduction, gains or losses. These adjustments are identified and reported on the partner's Schedule K – 1 they are generally viewed as follows:

a. Section 743(b) Positive Adjustments. Schedule K – 1 Line 11, Other Income or Loss Code F.

b. Section 743 (b) Negative Adjustments. Schedule K – 1, Line 13e, Other Deductions, Code V.

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.

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. 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.

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.

4. 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.

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.

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.

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. 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. 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.

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.

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. 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. Partnerships Get Penalty Relief for Failure to Furnish Payee Statements – Notice 2025 – 02, 2025 – 3 IRB

A. Form 8308: Report of a Sale or Exchange of Certain Partnership Interests

1. The IRS has provided additional penalty relief to partnerships that do not furnish Form 8308 to the transferor's and transferees of certain partnership interests exchanges occurring in 2024. The form must be provided no later than January 31, 2025.

2. Generally, partnerships report to the IRS information about certain exchanges of a partnership interest on the form. The form is generally do at the time for filing the partnership return including extensions. In addition, form requires the partnership furnish a copy to the transferor and transferee involved in exchange by the later of January 31 of the year following the calendar year in which the exchange occurred or 30 days after the partnership has received notice of the exchange.

3. The IRS imposes penalties for failure to furnish correct payee statements on or before the required date and for any failure to include all the information required to be shown on the statement or the inclusion of incorrect information.

4. The penalty relief only applies to a partnership's furnishing of the form to transferor and transferee's exchanges made during the calendar year 2024. It does not apply to a transferor partner's value to furnish a partnership notification. There is no penalty relief or penalties for failure to file corrected information returns.

5. The requirement to file the form is associated with Section 751 (a) exchanges. Section 751 (a) exchanges applies to appreciating value of inventory and unrealized receivables.

6. The beneficial owner of the partnership interest immediately before transferring the interest is not required to be disclosed. However, the form does indicate the type of partnership interest being transferred must be either capital, preferred, property or other and it must be identified.

7. A 751 election a socio-the transfer must also be disclosed as well as any disclosures of the sale associated with hot assets, collectibles and un-recaptured Section 1250 gain.

B. Additional Time – IRS Notice 2025 – 02

1. The IRS has announced that is providing additional relief from certain penalties imposed solely for failure of a partnership with unrealized receivables or inventory items to furnish Part IV Form 8308 to the transferor and transferee in certain transfers of partnership interest for 2024.

2. The reason for the penalty relief is that many partnerships continued lack information needed to comply with the reporting requirements in a timely manner. As a result, with respect to any of these changes occurring during county or 2024, the IRS will not impose penalties for the failure to furnish correct payee statements solely for the failure to furnish Form 8308 with a completed part IV if the partnership furnishes to the transferor or the transferee a corrected copy of Parts I, II and III of Form 8308 or a statement that includes the same information by the later of January 31, 2025 or 30 days after the partnership is notified of the exchange and a corrected copy of the complete Form 8308, including Part IV, or a statement that includes the same information is provided by the later of the due date of the partnership's 1065 or 30 days after the partnership is notified of the exchange.

3. The notice does not provide relief with respect to a transferor partner's failure to furnish the notification to the partnership required by this code section. Also, the notice does not provide relief with respect to filing Form 8308 as an attachment to the Form 1065.

XIV Partnership Penalties

A. Late Filing Penalty

1. For 2024, the failure to file penalty for partnership return or a S Corporation return is $245 per partner per month or per shareholder per month for 12 months. A penalty is assessed against the pastor if it is required to file a tax return and it failed to file the return by the due date including extensions or files a return that fails to show all information required unless a reasonable cause exception applies.

2. For 2025, that failure to file penalty for partnership returns or an S Corporation return is $255 per partner per month or per shareholder per month for 12 months.

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:

- 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.

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169**.**

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION VIII:

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.

3. Employers must use Form 8974 to determine the amount of the credit for the current quarter.

4. 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.

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

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.

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. 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.

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:

- 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.

5. The new rule is effective March 11, 2024

6. The final rule only revises the DOL's interpretation. It has no effect on other federal, state, or local laws that use different standards for employee classification. For example, the IRS has different statutory language and judicial precedent governing the distinction between employees and independent contractors, and those laws are interpreted and enforced by different federal agencies. The IRS has also not modified any of its published guidance based on the new final rule.

B. IRS Rule – Common Law Approach

1. The IRS refers to common-law rules related to determining whether an individual is an employee oran independent contractor, indicating the relationship of the worker and the business must be examined. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

2. The facts s that provide evidence of the degree of control and independence fall into three categories:

- Behavioral control – Does the company control or have the right to control what the worker does and how the worker does his or her job?
-
- financial control, and
- the type of relationship of the parties

3. Behavioral controls. The behavioral control factors fall into the categories of type of instruction given, degree of instruction, evaluation and training.

a. Types of Instruction. An employee is generally subject to the business's instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work.

- When and where to do the work.
- What tools or equipment to use.
- What workers to hire or to assist with the work.
- Where to purchase supplies and services.
- What work must be performed by a specified individual.
- What order or sequence to follow when performing the work.

b. Degree of Instruction. This means that the more detailed instructions, the more control the business exercises over the worker indicating that the worker is in fact an employee.

c. Evaluation System. If an evaluation system measures the detail how the work is performed, then that would mean the worker being an employee. If the evaluation measures just the end result, this can point to either an independent contractor or employee based upon facts and circumstances.

d. Training. If the business provides the worker with training on how to do the job, this indicates that the business wants the job done in a particular way. This is strong evidence that the worker is an employee. Periodic or on-going training about procedures and methods is even stronger evidence of an employer-employee relationship. However, independent contractors ordinarily use their own methods.

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.

4. Financial Controls. The financial controls fall into the categories of:

- Significant investment
- Unreimbursed expenses
- Opportunity for profit or loss
- Services available to the market
- Method of payment

a. Significant Investment. An independent contractor has significant investment in the equipment he or she uses in working for someone else. However, in occupation such as construction, workers spend thousands of dollars on tools and equipment they use and are still considered to be employees. There is no precise dollar limit that must be met to have significant investment.

b. Unreimbursed Expenses. Independent contractors are more likely to have these type of expenses then employees. Fixed ongoing costs that are incurred regardless or the work is currently being performed are noteworthy.

c. Opportunity for Profit or Loss. If a worker has a significant investment in the tools and equipment used and if that worker has unreimbursed expenses, the worker has a greater opportunity to lose money. Having that possibility of incurring losses indicates the worker is an independent contractor.

d. Services Available to the Market. An independent contractor generally free to seek out other business opportunities. They often advertise, maintain a visible business location and are available to work in relevant markets.

e. Method of Payment. Employees generally guaranteed a regular wage amount for an hourly, weekly or other period of time. This usually indicates that that worker is an employee even when the wage or salary is supplemented by commission. An independent contractor is usually paid by flat fee for the job. However it is common in some professions, like the practice of law, to be paid on an hourly basis as an independent contractor.

5. Types of Relationships. The factors for the types of relationship between parties generally falls into the following categories:

- Written contracts
- Employee benefits
- Permanency of the relationship

- Services provided as key activity of the business

a. Written Contracts. Although a contract may state that the worker is an employee or an independent contractor, this is not sufficient to determine the worker's status. The IRS is not required to follow a contract stating that the worker is an independent contractor, responsible for paying his or her own self employment tax. How the parties work together determines whether the worker is an employee or an independent contractor.

b. Employee Benefits. Employee benefits include things like insurance, pension plans, paid vacation, sick days, and disability insurance. Businesses generally do not grant these benefits to independent contractors. However, the lack of these types of benefits does not necessarily mean the worker is an independent contractor.

c. Permanency of the Relationship. If one hires a worker with the expectation the relationship will continue indefinitely, rather than for a specific project or timeframe, that is generally considered evidence that the intent was to create an employer – employee relationship.

d. Services Provided as Key Activity of the Business. If a worker provides services that are a key aspect of the business, it is more likely that the business will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

C. Section 530 Relief Provisions

1. 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. 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)

b. Substantive Consistency. The taxpayer must have treated the workers and any similar workers as independent contractors. If the taxpayer treated similar workers as employees, the relief provision is not available.

c. 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.

2. 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.

3. This provision applies to taxpayers in cases involving determinations of employment status, i.e. worker classification cases.

4. 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.

5. 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.

D. 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.

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,

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.

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.

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.

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:

- 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. 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.

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),

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169**.**

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION IX:

TAX EXEMPT ORGANIZATIONS

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)

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

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:

- 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

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.

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)

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169.

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION X:

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

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)

2. FBAR penalties assessed against taxpayers were not taxes imposed by the Internal Revenue Code and therefore are not subject to collection due process hearings regarding said penalties. (SC Jenner v. Comm., 163 TC __,No. 7,Dec. 62, 517)

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. Comm., TC 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 unreported 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.

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.

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.

LaRosa v. Comm., 163 TC No.2 Dec 62, 486. Taxpayer was not entitled to innocent spouse relief regarding erroneous refunds of interest because did not give rise to an unpaid tax or deficiency. The IRS had made an erroneous refund of interest to the taxpayer and her former husband. The taxpayer requested equitable relief in the IRS denied staying the liability arising from erroneous refund of interest was not eligible for relief. The taxpayer argued that the erroneous refund should be considered an unpaid tax because the refund was in action for the recovery of the tax. The taxpayer argued that the refund constituted an unpaid tax or deficiency because it was a rebate refund that could have been recovered through deficiency procedures. The erroneous refund was not a rebate because it did not involve any portion of the taxpayer's tax liabilities for the years at issue. The refund did not involve a recalculation of the tax liability as they were neither adjusted nor refunded. As such since the erroneous refund did not constitute an unpaid liability no innocent spouse relief is applicable.

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 $107,400 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 2024, payment card companies, payment apps, and online marketplaces will be required to send the taxpayer a Form 1099-K when the amount of your business transactions during the year is more than $5,000.

2. Also for 2024, if the taxpayer receives a Form(s) 1099-K that shows payments that were included in error or for personal items sold at a loss, the taxpayer will now enter these amounts in the entry space at the top of Schedule 1.

3. In calendar year 2025, the threshold will lower to more than $2,500 and for 2026 and later years, the threshold will be more than $600.

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)

D. Written Information Security Plan (WISP) Requirement – IR – 2024 – 201

1. The service continues to inform tax preparers they need to have a written data security plan in place and available for review.

2. The IRS has recently update a sample template for use by tax preparers in Publication 5708; Creating a Written Information Security Plan for your Tax and Accounting Practice.

3. The template made a couple of modifications. Specifically, it must have a multifactor authentication (MF A) this is a requirement for all tax professionals to protect clients sensitive data. The new MF a requires at least two of the following factors for anyone assessing client information:

- Something only a user would no like a username.
- Something sent to the taxpayer like numbers text to a cell phone.
- Recognition of the physical part of a person like a facial scan.

4. The MSA should be used to secure client information on a computer network and should be used to access client information stored in tax preparation software.

5. This is governed under the federal trade commission and opting out is a violation of FTC rules subject to fines and penalties.

E. US Supreme Court Decision on Chevron Doctrine

1. The Supreme Court delivered a landmark decision in Loper Bright Enterprises v. Raimondo which will alter the role of federal agencies in interpreting laws passed by Congress. In eight 6 – three ruling, the Supreme Court overruled the Chevron doctrine. Under the doctrine courts were required to defer to federal agencies interpretations of ambiguous statutes the agency's interpretation was deemed reasonable provided Congress had not directly addressed the issue.

2. The Court ruled that judges should no longer defer to agencies interpretations when a statute is ambiguous. Rather, courts are now required to independently interpret statutory language, reinforcing a stricter separation of powers and ensuring a more rigorous judicial review of agency actions.

3. The ruling will have an impact on treasury regulations in that judges must now independently assess whether the Treasury has acted within its statutory authority. Even if Congress grants regulatory power to the Treasury, courts are no longer obligated to defer to the Treasury's interpretations simply because they are reasonable.

4. With the new ruling courts may and must review Treasury regulations and interpretations leading not only to the additional and increased judicial scrutiny but disagreements with Treasury Interpretations.

5. The result of the heightened or stricter scrutiny will likely result in more appeals at the federal level and more appeals out of the Tax Court.

References:

The Inflation Reduction Act of 2022 (IRA 22), PL 117 – 169**.**

Consolidated Appropriations Act, 2023, HR 2617

The Coronavirus Preparedness and Response Supplemental Appropriations Act, PL 116 – 123, March 6, 2020

The Coronavirus Aid Relief, And Economic Security (CARES) Act, PL 116 – 123, Sections 1106 et al, March 27, 2020

H. R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019

H.R. 1, The "Tax Cuts and Jobs Act", P.L. 115-97.

SECTION XI:

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):

- **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.

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.
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.