CHECKPOINT LEARNING®

2021 GEAR UP

1040
Individual Tax

T40G—2021

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Acknowledgements

The authors wish to acknowledge the valuable source materials of PPC that were used in developing certain topics of this manual.

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Business Entities — One Day				*Available November 2021*
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Note: 2020 CPE expires Dec. 31, 2021.				

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Reference Manual Only	0	21-M13012	NA	$99
Note: 2021 CPE Credits recommended; 2020 CPE expires Oct. 31, 2021.				

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California Tax Update				*Available December 2021*
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Self-Study CPE Course (print-based manual and exam)	5	21-ME12005	$74	$99
Reference Manual Only	0	21-M13005	$59	$79
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Income Tax for Estates and Trusts—Form 1041				*Available November 2021*
Format	*CPE*	*Product ID*	*2020Tax Year*	*2021 Tax Year*
Self-Study CPE Course (print-based manual and exam)	7	21-ME12099	$112	$149
Reference Manual Only	0	21-M13099	$74	$99
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GFFS21

ACTION NOTES

Research studies have shown that if you don't use an idea within 24 hours of hearing it, you probably never will. So, if you hear something in this program that you'd like to try, write it down on this note sheet immediately. Keep this page handy and at the end of the course, you'll have all your new ideas in one place and ready to put into action.

Action Note	Page Ref.	I'll Start By . . .

Action Note	Page Ref.	I'll Start By . . .

PLEASE SUBMIT QUESTIONS IN WRITING

QUESTION: ______________________________

QUESTION: ______________________________

QUESTION: ______________________________

QUESTION: ______________________________

QUESTION: ______________________________

QUESTION: ______________________________

NOTES:

NOTES:

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GEAR UP CHEAT SHEETS

CHEAT SHEET 1A

2020–2022 Key Facts (2022 amounts per Rev. Proc. 2021-__)

	2020	2021	2022
Standard Deduction			
Single & Married Filing Separate	$12,400	$12,550	
Married Filing Joint and Qualified Widower	$24,800	$25,100	
Head of Household	$18,650	$18,800	
Additional Deduction for Elderly and Blind			
Single	$1,650	$1,700	
Married	$1,300	$1,350	
Dependent of Another			
Greater of $1,100 or $350 plus earned income, not to exceed regular single standard deduction	$1,100/$350	$1,100/$350	
Social Security			
FICA Taxable Wage Base	$137,700	$142,800	
Below FRA Social Security Earnings Limit	$18,240	$18,960	
Year FRA attained Social Security Earnings Limit	$48,600	$50,520	
Kiddie Tax	$2,200	$2,200	
Child Tax Credit			
Child under age 6	$2,000	$2,000	$3,600
Child over age 5 up to age 17 (16 for 2019 & 2020)	$2,000	$2,000	$3,000
Refundable Portion (Limits in Chapter 13)	$1,400	$1,400	***See Above***
Other Dependents	$500	$500	$500

	2020	2021	2022
Per Diem Rates			
Business/Depreciation Per Mile	57.5¢/27.0¢	56.0¢/26.0¢	
Medical/Moving	17.0¢	16.0¢	
Charitable Mileage	14.0¢	14.0¢	14.0¢
M&IE Daily Rates ***US/Non/Continental***	$66/$71	$66/$71	
Qualified Parking/Mass Transit Fringe	$270	$270	
IRC Sec. 179			
Depreciation	$1,040,000	$1,050,000	
Investment Limitation	$2,590,000	$2,620,000	
SUV Limitation	$25,900	$26,200	
Luxury (Non-Electric) Auto Depreciation Limits			
First Year Bonus Depreciation	$8,000	$8,000	
Year 1	$10,100	$10,200	
Year 2	$16,100	$16,400	
Year 3	$9,700	$9,800	
Year 4 and after	$5,760	$5,860	
Leased Auto Inclusion Applies at FMV	$50,400	$51,000	
Annual Gift Exclusion	$15,000	$15,000	
Basic Estate Exclusion Amount	$11,580,000	$11,700,000	

CHEAT SHEET 1B

	2020	2021	2022
IRA			
Base Contribution	$6,000	$6,000	
Age 50+ Catch Up	$1,000	$1,000	
Simple IRA			
Base Contribution	$13,500	$13,500	
Age 50+ Catch Up	$3,000	$3,000	
Section 401(k), 403(b), and 457 Plans			
Base Contribution	$19,500	$19,500	
Age 50+ Catch Up	$6,500	$6,500	
IRC 415 Limits			
Contribution Limit	$57,000	$58,000	
Defined Benefit Limit	$225,000	$230,000	
Compensation Limit	$285,000	$290,000	
HSA Limitations (Rev. Proc. 2021-25)			
Self-Plan	$3,550	$3,600	$3,650
Family-Plan	$7,100	$7,200	$7,300
Age 55+ Catch Up	$1,000	$1,000	$1,000
Minimum Deductible – Self-Plan	$1,400	$1,400	$1,400
Minimum Deductible – Family-Plan	$2,800	$2,800	$2,800
Maximum Deductible – Self-Plan	$6,900	$7,000	$7,050
Maximum Deductible – Family-Plan	$13,800	$14,000	$14,100
Maximum Excepted Benefit HRA	$1,800	$1,800	$1,800

	2020	2021	2022
Long Term Care Deduction Limitations			
Age 40 or younger	$430	$450	
Age > 40 to 50	$810	$850	
Age > 50 to 60	$1,630	$1,690	
Age > 60 to 70	$4,350	$4,520	
Age > 70	$5,430	$5,640	
FSA Deferral Amt. Limit	$2,750	$2,750	
Cash Accounting Threshold [IRC Sec. 448(c)] and Net Business Interest Threshold [IRC Sec. 163(j)]	$26,000,000	$26,000,000	
AMT Exemption [IRC Sec. 55(d)] Phase-Out of Exemption is 25% of AMTI Exceeds Threshold			
Single and Head of Household	$72,900	$73,600	
Phase-Out Begins (Threshold)	$518,400	$523,600	
Married (MFS is ½ of Married)	$113,400	$114,600	
Phase-Out Begins (Threshold)	$1,036,800	$1,047,200	
Excess Bus. Loss Thresholds [IRC Sec. 461(j)]			
Non-Joint Filer	$259,000	$262,000	
Joint Filer	$518,000	$524,000	
Income Based Limitation (IRC Sec. 199A)			
Single/HOH	$163,300	$164,900	
Joint	$326,600	$329,800	
Married Filing Separate	$163,300	$164,925	

CHEAT SHEET 1C

	2020	2021	2022
Capital Gains – 0% Rate			
Single/MFS	$40,000	$40,400	
Joint	$80,000	$80,800	
Head of Household	$53,600	$54,100	
Estates and Trusts	$2,650	$2,700	
Capital Gains – 15% Rate			
Single	$441,450	$445,850	
Married Filing Separate	$248,300	$250,800	
Head of Household	$469,050	$473,750	
Married Filing Joint	$496,600	$501,600	
Estates and Trusts	$13,150	$13,250	

SAMPLE FEE SCHEDULE FOR 2022 FILING SEASON FORM 1040 TAX PREPARATION

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Repossession	450

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The minimum fee for any new return is $450 (except dependents $225)
Discount certain returns received by 2/15/22

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Discounts

Dependents	**Varies**
Married Filing Separately	**Varies**
Good Records	**Varies**

Audit Guarantee

The greater of $100 or 15% of the bill.

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Other Returns

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All eligible returns will be electronically filed at no additional charge. This applies only to returns originally prepared by our firm.

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- This is a minimum fee schedule which can be increased if extra time is required.
- # / # is a typical low / high range.
- Study based on hourly rate of $150 for the preparer and $250 for the reviewer

CHAPTER 1: WAGES AND OTHER INCOME

Learning Objectives

Completion of this chapter will enable participants to—

- Describe the increased IRS compliance requirements regarding virtual currencies.
- Identify issues associated with unemployment compensation, including the tax exemption for UEC.
- Identify other taxable income and available exclusions.

WHAT'S NEW THIS YEAR

1. Modifications to Form 1040 or Form 1040 SR – Schedule 1
2. Exemption from taxation for up to $10,200 of UEC for 2020.
3. Updated Information on Pandemic Unemployment Program
4. The American Rescue Plan provides an exemption from taxation of unemployment compensation (UEC)
5. The IRS's additional enforcement procedures regarding cryptocurrency transactions.
6. The IRS request for tax practitioner assistance in limiting UEC claims fraud.

MODIFICATIONS TO DRAFT FORM 1040, SCHEDULE 1

The draft of Schedule 1 indicates a significant modification as of the date this manual went to press. Schedule 1 for 2021 has been modified to a two-page form, with Part 1 Additional Income on Page 1 and Part II Adjustments to Income on Page 2.

The 2020 version of Part 1 contained eight lines which accepted numeric information, the 2021 version contains 24 numeric input lines with a subtotal for 18 items on Lines 8a–8z on Line 9. Line 10 is a total of Lines 1–7, plus the subtotal on line 9, for a total additional income adjustment to be entered on Line 10. Line 10 on Schedule 1 will be transferred from Schedule 1 to Line 8, Other Income, of Form 1040.

On Page 2 of Schedule 1, all Adjustments to Income will be entered. The 2020 version contained 12 lines of information/numeric values. There are 24 numeric entry lines on 2021 Part II Adjustments to Income, Lines 11–23, and there are 12 lines on 24a–24z which will be totaled and entered on Line 25. Lines 11–23 plus Line 25 will be added together on Line 26. Line 26 will be entered on Form 1040 Line 10, Adjustments to Income.

EXCLUSION OF UNEMPLOYMENT COMPENSATION FOR 2020

As a result of ARPA 2021, up to $10,200 of unemployment compensation (UEC) for 2020 was excludable from taxable income. Those taxpayers with modified AGI below the $150,000 threshold will be eligible to exclude their UEC or $10,200 whichever is less:

Taxpayers were eligible to exclude the unemployment compensation if it was received in 2020 and their modified adjusted gross income (AGI) was less than $150,000. The modified AGI for purposes of qualifying for this exclusion is adjusted gross income for 2020 minus the total unemployment compensation received. This threshold stays the same for all filing statuses, regardless of whether married and file a joint or separate tax return.

EXAMPLE: Determining UEC exclusion eligibility

Taxpayer is single and AGI amount on Line 11 of Form 1040 is $170,000. The amount on Schedule 1, Line 7, is $25,000. Subtract the $25,000 amount from $170,000, the result is $145,000. Taxpayer's modified AGI is $145,000 for the purpose of determining if modified AGI is less than $150,000 to qualify for this exclusion.

OBSERVATION: Will the UEC exemption be extended for 2021? A vast majority of commentators indicate no. This was not popular with a large number of senators, and the UEC exemption is accordingly likely to be a one-year provision.

SHOULD AN AMENDED RETURN BE FILED FOR 2020 UEC RECIPIENTS?

For those taxpayers who had UEC and filed their returns prior to March 11th of 2021 for 2020, the major question was should an amended return be filed? On March 31st, 2021 in IR-2021-71, the Internal Revenue Service announced that it will take steps to automatically refund money this spring and summer to people who filed their tax return reporting unemployment compensation before the recent changes made by the American Rescue Plan.

Practitioners immediately sounded an alarm that many taxpayers still faced having to file an amended return to correct their 2020 returns as a result of the UEC exemption. The IRS indicated in IR-2021-151 that it will be processing about 4 million refunds; however, there are actually about 4.6 million returns that will require some kind of adjustment. The IRS started issuing checks in mid-July and expected to have the 4 million refunds issued by the end of August.

Taxpayers *do not* need to file an amended return (per IR-2021-151) if they—

- already filed a tax return and did not claim the unemployment exclusion; the IRS will determine the correct taxable amount of unemployment compensation and tax,
- have an adjustment, because of the exclusion, that will result in an increase in any non-refundable or refundable credits reported on the original return,
- did not claim the following credits on their tax return but are now eligible when the unemployment exclusion is applied: Recovery Rebate Credit, Earned Income Credit with no qualifying dependents or the Advance Premium Tax Credit. The IRS will calculate the credit and include it in any overpayment,
- filed a married filing joint return, live in a community property state, and entered a smaller exclusion amount than entitled on Schedule 1, line 8 (this is caused by an error on the initial UEC exclusion worksheet).

Taxpayers should file an amended return if they—

- did not submit a Schedule 8812 (see Chapter 13, Personal and Business Tax Credits) for additional discussion on this issue) with the original return to claim the Additional Child Tax Credit and are now eligible for the credit after the unemployment compensation exclusion,
- did not submit a Schedule EIC with the original return to claim the Earned Income Tax Credit (with qualifying dependents) and are now eligible for the credit after the unemployment compensation exclusion,
- are now eligible for any other credits and/or other deductions. Make sure to include any required forms or schedules, or
- the taxpayer did not receive a refund from an otherwise qualifying return.

EXAMPLE: When to file an amended return to ensure credits and a full refund are applied

The IRS furnished the following example of when to file an amended return to ensure that the full amount of credits and refund are applied to the return.

> You didn't claim the Earned Income Tax Credit (EITC) or the Additional Child Tax Credit (ACTC) for your qualifying children on your 2020 tax return because your AGI was too high. Because the unemployment compensation exclusion reduced your AGI, you're now eligible for an EITC or ACTC. However, you need to file an amended return including a Schedule EIC to claim the EITC, Schedule 8812 to claim ACTC, and any other credits not claimed on your original return and not meeting the exception above. If, instead, you claimed $50 in EITC on your 2020 tax return, don't file a Form 1040-X solely to change the EITC amount. The amount of this and other credits that you claimed on the original return will automatically be adjusted by the IRS when applying the exclusion.

OBSERVATION: It is likely that the UEC refund program will have issues and that numerous taxpayers will not receive their refund from the change in UEC taxation by ARPA 2021 without filing a claim. The best solution when an expected refund has not been received is to review the 2020 transcript for the taxpayer (see Chapter 20 for details how that process works). All but 11 states “coupled” with the federal, which means that a state amended return may also need to be filed.

PANDEMIC UNEMPLOYMENT PROGRAMS

There have been several acts which address UEC availability and/or taxation of UEC:

- The CARES Act 03/27/2021 included—
  - Pandemic Unemployment Assistance (PUA) in Section 2102.
  - Federal Pandemic Unemployment Compensation (FPUC) in Section 2104, and
  - Pandemic Emergency Unemployment Compensation (PEUC) in Section 2107.

- The Consolidated Appropriations Act (CAA) 12/27/2020
- The American Rescue Plan Act (ARPA) 03/11/2021

Pandemic Unemployment Assistance (PUA)

The PUA program assisted individuals who did not qualify for regular unemployment compensation and were unable to continue working as a result of COVID-19, including self-employed workers, independent contractors, and gig workers. Also included were those seeking part-time employment, and individuals lacking sufficient work history.

The PUA program provided up to 39 weeks of benefits to qualifying workers who were otherwise able to work and available for work but were unemployed, partially unemployed, or unable or unavailable to work due to COVID-19 related reasons. Benefit payments under PUA are retroactive starting on or after January 27, 2020. PUA benefits ended for weeks of unemployment ending after December 31, 2020.

The program was administered by state offices of unemployment compensation. To speed payment, debit cards were issued to recipients.

UEC PROGRAMS PROVIDED BY THE CARES ACT

Pandemic Emergency Unemployment Compensation (PEUC)

The PEUC program allowed those who had exhausted benefits under regular unemployment compensation or other programs to receive up to 13 weeks of additional benefits.

Qualified individuals included those who—

1. Exhausted all rights to regular compensation under state law or Federal law with respect to a benefit year that ended on or after July 1, 2019,
2. Had no rights to regular compensation with respect to a week under any other state UEC law or Federal UEC law, or to compensation under any other federal law,
3. Were not receiving compensation with respect to a week under the UC law of Canada, and
4. Were able to work, available to work, and actively seeking work.

Federal Pandemic Unemployment Compensation (FPUC)

Under FPUC, states administered an additional $600 weekly payment to certain eligible individuals who were receiving other benefits.

Under the FPUC program, eligible individuals who were collecting certain UEC benefits, including regular unemployment compensation, received an additional $600 in federal benefits per week for weeks of unemployment ending on or before July 31, 2020.

To provide assistance and assurance to those eligible, the benefit payments under FPUC may begin as soon as the week after the execution of a signed agreement between the DOL and states.

The timeline for these payments will vary by state. As states began providing this payment, eligible individuals received retroactive payments back to their date of eligibility or the signing of the state agreement, whichever came later.

All states had executed agreements with the DOL as of March 28, 2020. FPUC benefit payments will end after payments for the last week of unemployment before July 31, 2020.

Additional Extensions Provided to PEUC and PUA Benefits

The president issued on August 8th of 2020 a directive to FEMA to approve lost wage assistance program allowing state governors to supplement state benefits by $400.

Federal assistance of PEUC and PUA benefits was extended and expanded first by CAA (12/27/2020) and then by ARPA (03/11/2021) to allow federal payment assistance to state UEC programs lasting until September 6th of 2021.

The duration of PEUC benefits was increased from 24 to 53 weeks. These benefits were paid to those who were initially eligible for state benefits but exhausted them prior to finding employment.

The duration of PUA benefits was also increased from the initial 50 to 79 weeks. In addition, for those in high unemployment states benefits were made available for a total of 86 weeks. Those eligible were those were not eligible for state benefits, including the self-employed, if they could demonstrate that their job loss was due to a COVID-19 related reason.

IRS AND SECURITY SUMMIT REQUESTS HELP FROM TAX PROFESSIONALS TO ADDRESS UEC FRAUD

In August 2021, the IRS and Security Summit asked for help from tax professionals to assist taxpayers who had been the victims of UEC fraud (IR-2021-163). The Labor Department estimates that almost $89 billion was lost to fraud in 2020. These falsified UEC claims were reported as income on Form 1099-G by state departments of labor. The IRS does not want the taxpayer to report the fraudulent amounts included on the return and then excluded. The IRS and the Security Summit team also noted that this fraud could easily affect the 2021 returns to a greater degree, as there is no UEC exemption for 2021.

The IRS has requested that the fraudulent income not be reported on the taxpayer's return. The service has also asked that the following other steps also be taken when they apply:

1. File Form 14039, Identity Theft Affidavit but, only if an e-filed tax return is rejected because the client's Social Security number has already been used. *Do not* file Form 14039 to report unemployment compensation fraud to the IRS.

2. Report the fraud to state workforce agencies, and request a corrected Form 1099-G. Each state has its own process for reporting unemployment compensation fraud. The U.S. Department of Labor has created an information page with all state contacts and other information at **www.dol.gov/fraud**.

3. File a tax return reporting only the actual income received. State workforce agencies may not be able to timely issue a corrected Form 1099-G. Even if the client has not received a corrected Form 1099-G, report only wages and income actually received and exclude any fraudulent claims.

4. Consider an IRS Identity Protection PIN. Clients receiving Forms 1099-G are identity theft victims whose personal information could be used for additional criminal activities, such as filing fraudulent tax returns. All taxpayers who can verify their identities can now obtain an Identity Protection PIN to protect their SSNs. (More information about IP PINs can be found in Chapter 19.)

5. Follow Federal Trade Commission recommendations for identity theft victims. Taxpayers should consider steps to protect their credit and other actions outlined by the FTC. The DOL also includes this information at **www.dol.gov/fraud**.

6. Tax professionals' business clients can also assist in fighting unemployment compensation fraud by responding quickly to state notices about employees filing jobless claims, especially when it has no record of those employees.

FORM 1099-NEC VERSUS FORM 1099-MISC

Tax year 2020 found a change in the reporting of non-employee compensation with the addition of Form 1099-NEC. It was noted by the IRS that several errors were made by taxpayers when reporting amounts on the two forms. As reported by IRS there were two primary errors:

1. Reporting amounts on Form 1099-MISC that were required to be reported on Form 1099-NEC, and

2. Confusion over the due date of Form 1099-MISC and Form 1099-NEC.

Form 1099-NEC is to be filed when the following conditions are met:

1. The payment was made to a person who was not an employee, and

2. The payment was made in the course of a trade or business, and

3. The payment was made to an individual, partnership, or estate. In some limited circumstances the reporting may apply to corporations, and

4. The total payments for the calendar year were in excess of $600.

The Form 1099-NEC is to be furnished to the non-employee on or before 01/31/2022 and the Form is to be provided to the IRS on or before the same day 01/31/2022. There is no postponed due date as a result of electronic filing.

Form 1099-MISC is to be filed when the following conditions are met:

1. At least $10 in royalties or broker payments in lieu of dividends or tax-exempt interest.

2. At least $600 in the following:

    a. Rents

    b. Fishing Boat Proceeds

    c. Substitute Payments in Lieu of Dividends or Interest

    d. Gross Proceeds Paid to an Attorney

e. Nonqualified Deferred Compensation

f. Other Income – Not non-employee comp

g. Medical and Health Care Payments

h. Crop Insurance Proceeds

i. Section 409A Deferrals

Form 1099-MISC is due to the recipient by 01/31/2022 and due to the IRS by 02/28/2022 or if filed electronically 03/31/2022. During the prior year the service noted there were a large number of documents that were either not filed timely or non-employee compensation was reported as other income on Form 1099-MISC.

DIGITAL (I.E., VIRTUAL OR CRYPTO) CURRENCY

FORM MODIFICATION ALERT: The question regarding virtual currency which appeared on Form 1040 or Form 1040 SR for 2020 has been modified on the draft 2021 Form 1040 and 1040 SR (the question did not, however, move from its location in 2020).

The 2020 question read as follows:

> "At any time during 2020, did you receive, sell, **send**, exchange, or otherwise **acquire** any financial interest in any virtual currency?"

The 2021 question will read as follows:

> "At any time during 2021, did you receive, sell, exchange, or otherwise **dispose of** any financial interest in any virtual currency?"

The term *send* has been eliminated, and the term *acquire* has been replaced with *dispose of*. With these changes, it appears the IRS is focusing on taxable transactions (e.g., sales of cryptocurrencies) versus non-taxable transactions (e.g., acquisitions). This change would mean a taxpayer who purchased virtual currency or transferred currency between accounts with no other transactions would check the "no" box in 2021, rather than being required to check the "yes" box as in 2020.

The IRS website currently has FAQs regarding basic information on VC transactions, (**www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions**) as well as an additional resource for complying with the response to the VC question on the 1040.

What once was fringe is now mainstream, as corporations and even governments compete to create their own version of the cryptocurrency. Currently, the Chinese government is developing a digital "yuan." A digital currency with full government backing potentially makes its banking system redundant.

"Blockchain" technology is the basis for virtual currency, which is an immutable ledger for recording and maintaining the history of data. It creates a clear trail for recording transactions and tracking assets. In Notice 2014-21, the IRS indicated that digital currency such as Bitcoin was a form of property.

Digital currency received as payment for goods or services is income when received. The income is based on the fair market value (FMV) of the virtual currency received. Taxpayers recognize a gain or loss on the sale or disposition of digital property based on the value received. The character of the gain or loss is dependent on how the taxpayer holds the property. "Property" treatment causes both valuation and tracking issues. Websites differ on the value. Value changes on a moment to moment basis. Businesses using this technology must account for thousands of transactions taking place in seconds.

EXAMPLE: Digital currency received as payment for goods or services

The taxpayer agreed to sell widgets for a price of $100,000 but agrees to take payment in the form of virtual currency (VC). Since VC is considered property and the FMV of the VC accepted as payment was in fact $102,000 when received, $102,000 is considered to be the sale price. The basis of the VC in the hands of the seller will be $102,000. If the taxpayer later transfers that VC using it for purchase when the FMV is $105,000 (assuming that transfer occurred less than one year after receiving the VC in the initial transaction), the taxpayer will be considered to have sold the VC for $105,000 recognizing a short-term gain of $3,000.

The TJCA provided an additional hurdle to taxpayers with gains in digital currency by eliminating like-kind treatment for property other than real estate. No longer could the risks associated with one type of currency be reduced by moving to another currency without income recognition.

NOTE: The IRS's position has been that cryptocurrency was never eligible for Section 1031 treatment. On June 18, 2021 the IRS took its first serious affirmation of that position with the issuance of ILM 202124008 indicating a more formal statement of its position regarding three specific currencies.

The Increasing Compliance Posture VC Transactions

TIGTA issued a report on the lack of compliance with reporting requirements as outlined by IRS Notice 2014-21. In response to the TIGTA report in August 2017, the IRS announced a concern over "massive" underreporting of income generated by cryptocurrencies. Since the beginning of Commissioner Charles Rettig's appointment, there has been an increased focus on VC. In the last several years there has been a flurry of activity by Treasury, the IRS, and the White House:

1. On May 20, 2021 the Treasury Department announced that it will require any VC transfer of $10,000 or more to be reported to the IRS.

2. The federal courts continue to allow the use of the "John Doe" summons to determine individuals who have participated in VC transactions. The IRS has labeled this collection of requests "Operation Hidden Treasure:"

    a. On April 1, 2021, a federal court in Massachusetts agreed with the IRS request that Circle Internet Financial Inc. disclose any taxpayers who conducted the equivalent of $20,000 in VC transactions between 2016 and 2020.

    b. On May 5, 2021, a federal court in California, at the request of the IRS, ordered Kraken Crypto Exchange to release detailed personal information on named investors which the IRS had reason to believe had failed to report VC transactions. This specific request was made as a result of the Coinbase summons in 2019.

3. The IRS disclosed that they are seeking Congressional statutory authority to require the reporting of all taxpayers for any transfer of $10,000 or more of VC, as the capitalization of the VC market has grown to over $2 trillion.

4. Further, the White House is now calling for a $10,000 reporting threshold on VC transactions. The numbers placed on the proposal by the Biden Administration indicates they believe this requirement would raise over $70 billion annually over the next 10 years, growing to $160 billion annually after that.

In March 2020, the IRS held an invitation-only Virtual Currency Summit that consisted of a panel Q&A session. In "Highlights from the IRS Virtual Currency Summit" (*Forbes*, 3/9/2020), Shehan Chandrasekera summarized the following topics discussed at the summit:

1. Common misconception that VC is anonymous. VC uses the VC address as its method of identification. All transactions associated with the address are traceable and permanently stored in the network. Many users have revealed their identity to receive the goods or services. Further what might not be traceable today could become traceable in the future. As per IRS Commissioner Rettig "We have no idea where the dollar bill in your pocket was before you had it. We know exactly where your VC was before you got it."

2. An IRS agent who contributed to the first VC tax guidance in Notice 2014-21 noted that the classification of cryptocurrency has caused a lot of confusion. Given the evolution of the industry, the IRS is aware that property treatment may not be suitable for all cryptocurrencies.

3. Various governmental agencies treat cryptocurrencies differently. The SEC treats VC as securities. The U.S. District Court in New York determined that digital currency is a commodity which can be regulated by the U.S. Commodity Futures Trading Commission [*Commodity Futures Trading Comm. vs. Patrick K. McDonnell and Cabbagetech Corp.*, Memorandum & Order 18-CV-361 (JBW)]

4. There are numerous cryptocurrency tax calculators, but many have proven to be inaccurate. Taxpayers should consider using trackers that are endorsed by the SEC, accounting firms, and users.

5. The IRS is proposing a Central Depositary to improve cryptocurrency tax compliance. Representatives from Coinbase and Kraken have pushed back on this due to perceived security and privacy risks.

6. The AICPA commented that large donations of crypto assets are being hampered by the "qualified appraiser" requirement for donations of property on more than $5,000.

7. Practitioners still have issues concerning the VC tax question and what it covers. The instructions are sparse, and it is unclear what is covered under the "financial interest" category of the question.

The question most frequently asked is, "What is the future IRS posture for compliance of VC?" Congress has expressed frustration over the years with the lack of acknowledgement of an issue by IRS. The Biden Administration views the VC world as an opportunity to capture an ever-increasing amount of "tax gap" represented by VC. The IRS, in its first legitimate admission that they are playing catch-up with users of VC, has enlisted the tax automation software used by many of the VC players of the world: TaxBit.

TaxBit's tax automation software is already being used by companies, consumers, and other government agencies, but the deal with the IRS represents a major step in demonstrating how seriously the IRS is taking tax compliance for users of digital and virtual currencies like Bitcoin, Ether, and Dogecoin. TaxBit will soon be working with the IRS, and its reports will be shared not only with the IRS, but with the taxpayers themselves, as well as the CPAs and attorneys who represent them during audits.

While there are great consulting and income opportunities for those who embrace this technology, its challenges cannot be ignored. Cryptocurrency accounting is complicated. It is too dynamic for a static spreadsheet. Systems need to be in place to deal with the reporting and tax compliance demands. Systems will have to evolve as cryptocurrency demands bring widespread change in the financial industry.

The IRS believes that millions of transactions are not reported annually. With greater enforcement, those who fail to comply face substantial penalties and, in some cases, criminal prosecution. Anyone convicted of tax evasion can be subject to 5 years' imprisonment and fines as high as $250,000.

Clients who have failed to report their casual cryptocurrency activities should consider filing amended returns to avoid assessment of future penalties. Those who have blatantly disregarded the rules should consider engaging an attorney.

WARNING: The Senate version of the Infrastructure Bill would amend Code Sec. 6045 requiring brokers to report any transfer to a non-brokerage account to IRS. As noted earlier the White House, Congress, Dept. of the Treasury, and Internal Revenue Service are united in their desire to increase transactional reporting of VC transactions to address the perceived abuses of VC. The result of the amendment of Code Sec. 6045 may result in almost all VC transactions being reported to IRS. Keep your eyes open and discuss with your client the possible administrative burdens that could be associated with this proposal.

OBSERVATION: FinCEN Notice 2020-2, indicates VC is not a reportable foreign account. FinCEN will be seeking in 2021 to require the FBAR reporting of VC holdings. The proposal states—

> FinCEN intends to propose to amend the regulations implementing the Bank Secrecy Act (BSA) regarding reports of foreign financial accounts (FBAR) to include virtual currency as a type of reportable account under 31 CFR 1010.350.

While foreign cryptocurrency accounts do not *currently* qualify as foreign financial accounts under the Bank Secrecy Act (although they may qualify soon), virtual currencies held offshore *may* qualify as foreign financial assets under FATCA. While the FBAR filing requirement does not currently apply to cryptocurrency investors (unless their foreign accounts also hold reportable assets), the FATCA filing requirement does. Like the Bank Secrecy Act, FATCA imposes substantial penalties—including criminal penalties for willful and intentional violations.

CROWDFUNDING

Crowdfunding consists of raising small amounts of money from a large number of individuals to finance a project, venture, or charitable cause via contributions and donations via websites and other registries and methods (e.g., mail-order subscriptions, benefit events). It is considered a form of "alternative financing" outside traditional means of obtaining financing.

The number of crowdfunding platforms has surged in the last several years. Differing sites are better suited for certain projects than other sites. According to Crunchbase.com there are about 1,500 (in 2021) crowdfunding sites in the U.S. which supported 6,445,000 campaigns (Fondly.com, 2020) and raised around $34 billion (Fondly.com, 2020). What is most important is that the various sites are each best at different campaigns (**www.investopedia.com/best-crowdfunding-platforms-5079933**). The following can be helpful in understanding the impact of crowdfunding:

1. The annual growth rate of crowd funding is currently estimated at >16%.

2. Most crowdfunding campaigns in the U.S. are those attempting to support "gift" causes.

3. The U.S. leads the world in the amounts raised via crowdfunding by a margin of about 3.5:1.

4. Using the correct site for the intended result can smooth out the process.

NOTE: For enterprises wanting to raise less than $500,000, crowdfunding is a viable alternative. However, for larger capital goals, numerous restrictions exist which are beyond the scope of this manual.

Much of the uncertainty has centered on the taxability of funds raised through crowdfunding sites, as it is being used to assist private causes that once were funded by small local fundraisers. Contributions through most sites *are not* generally deductible donations but goodwill offerings (i.e., gifts). Currently, the primary school of thought is that the funds raised fall into one of four categories:

1. **Charitable Donation.** The campaign must be supported by a registered non-profit organization.

PLANNING TIP: The IRS ruled that an organization that provided a crowdfunding platform was not tax exempt under IRC Sec. 501(c)(3). The sole activity of the organization was to provide a crowdfunding platform to raise money for charitable programs for organizations tax exempt under IRC Sec. 501(c)(3). However, the organization itself is carrying on a business for a profit. Additionally, the organization did not meet the operation requirement of a tax-exempt organization. (PLR 201814009)

2. **Gifts.** A gift is a transfer without an expectation of a return other than goodwill. Accordingly, a transaction that promises a return for a contribution would not qualify as non-taxable gift.

CAUTION: In a lesson that *no good deed goes unpunished*, or perhaps *take time to organize the good deed correctly*, Connecticut teacher Louis Goffinet started an online fund-raising effort in 2020. By using Facebook and its payment program, he managed to raise almost $45,000, which was subsequently deposited into his personal bank account.

In February 2021, Mr. Goffinet received a Form 1099-K reporting the funds to the IRS. Even though Mr. Goffinet had determined who should be the beneficiary of his efforts, since the funds were deposited to his personal account, the IRS maintains that he owes taxes on the $45,000. It could be argued that the funds were provided to him by those who supported his funding effort on Facebook and provided the funds with what we call a *detached sense of generosity*. Based on advice from a local tax accountant, future fund-raising will be made through a "charitable organization" which has been organized to support Mr. Goffinet's efforts.

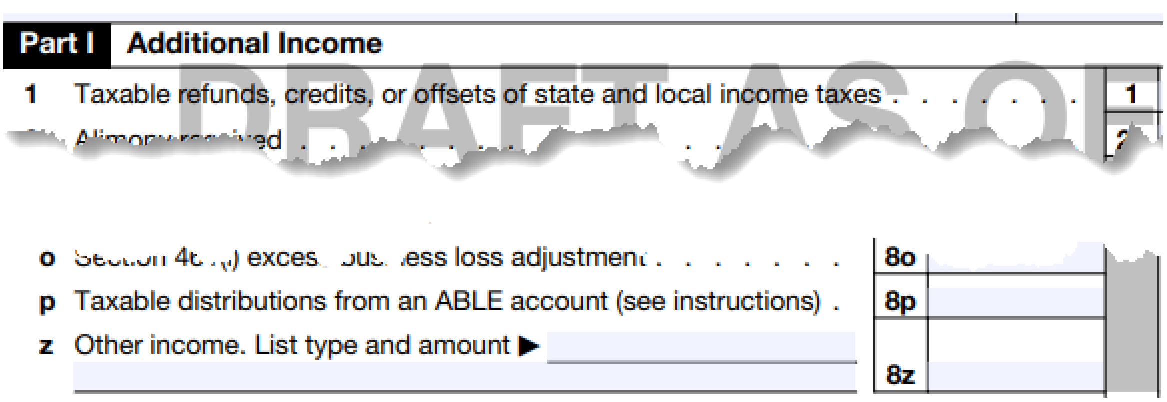
3. **Charitable Contribution.** There are sites that serve nonprofits and potentially could generate a charitable contribution to the donor. Sites such as **https://doublethedonation.com** deal exclusively with qualified charities.

4. **Taxable Income.** If the contributor receives something of value, the IRS will treat it as a business transaction. Many crowdfunding campaigns take a conservative position which treats the transfer as a sale. State tax law may consider the transfer as a taxable sale subject to sales tax. Potentially, contributions for stock in a venture could be treated as capital contributions.

Any required reporting will occur on Form 1099-K (the form we associate with credit card receipts) which is not a determination of earned income. When there are 200 or more transactions yielding $20,000 or more, the form is required by regulation. The IRS "assumes" that these funds are income when reported unless the taxpayer indicates otherwise.

Some sites, such as **https://go.wepay.com**, indicate they have guidance from the IRS that no Form 1099-K reporting is required. The actual authority for not issuing a Form 1099-K comes from IRC Sec. 6050W and its related Regulations. That guidance indicates that no Form 1099-K is required in situations where no goods or services are provided.

OBSERVATION: Many recipients involved in nontaxable crowdfunding transactions continue to receive Form 1099K. If this form is received, report the amount on line 8z of Schedule 1 of the Form 1040. Then subtract the amount reported on Form 1099-K on line 8z also. In many cases this will quiet any IRS inquiries.


Part I Additional Income

1 Taxable refunds, credits, or offsets of state and local income taxes 1

o Section 461(l) excess business loss adjustment 8o

p Taxable distributions from an ABLE account (see instructions) . 8p

z Other income. List type and amount ▶ 8z

The IRS has provided little guidance to assist in making the determination of the exact nature and character of proceeds from these campaigns. In Information Letter 2016-0036 (June 24, 2016), the IRS attempted to address whether the "receipts" from crowdfunding are taxable as income. IRC Sec. 61(a) provides that all accessions to wealth are in fact income unless Congress has provided a specific exclusion.

Reg. 1.451-2 sets out the constructive receipt doctrine, which provides that when a taxpayer obtains dominion and/or control of an asset, they have in fact ascended to wealth. Only when the "wealth" is not under the taxpayer's control is it not considered income; however, upon the taxpayer having control of the wealth, it will become income unless IRC Sec. 61 provides a specific exemption.

In the information letter provided by the IRS, a general statement was made indicating that "generally, money received without an offsetting liability (such as a repayment obligation), that is neither a capital contribution to an entity in exchange for a capital interest in the entity or a gift, is includable in income."

An equity interest of the venture is received in return for the contribution. To further define what is taxable and what is not, the IRS indicated the following will never be taxable, as must be a clear stipulation attached to the funding:

1. Loans that must be repaid,

2. Capital contributed to an entity in exchange for an equity interest in the entity, or

3. Gifts made out of a detached generosity and without a *quid pro quo*. However, the service went on to say that not all voluntary transfers without a *quid pro quo* are in fact gifts for federal income tax purposes. This leaves the door open for a significant amount of post transactional second-guessing in the absence of a clear indication of the intention of the parties.

While Information Letter 2016-0036 was intended to provide some level of guidance for crowdfunding activities, it ultimately failed to do so. The IRS closed with a statement that each crowdfunding effort's taxable status would be a facts-and-circumstances test controlled by statutory requirements.

OBSERVATION: If the creator of the fund is not the beneficiary; they should make that clear on the website that it was created for a beneficiary. They should request "donations" and state that nothing of value will be received in return. A screenshot copy(s) of the website should be taken in case the website is gone when the IRS requests information. The beneficiary should keep a record of what the money was used for. This will help protect the creator and beneficiary from a taxable event.

OTHER INCOME

Gross income includes all income from any source except those specifically excluded by the Code (IRC Sec. 61). The courts have reaffirmed that most income is subject to tax unless specifically excluded.

Nearly all wealth accession is taxable, but there are some exceptions under IRC Sec(s). 101 through 139A. (Foreign earned income also has special rules.) Gross income is generally taxable, regardless of whether it was received by mistake, limited in use, or illegally received.

PLANNING TIP: Taking documents at face value is not always the best answer for the client. Probe not only for tax reporting documents but what event created the amounts reported by the document.

CREDIT CARD REWARDS FOR PURCHASES OF GIFT CARDS

The IRS has had the long-standing position that credit card reward programs are not taxable income but are in fact reductions of the costs of the purchases (Rev. Rul. 76-96) made with those cards. In *Anikeev* (T.C. Memo 2021-23), the IRS attempted to change that longstanding ruling. The taxpayer had determined a methodology under the Visa and American Express gift card program to purchase a gift card, convert the card to cash by exchanging the card for a money order, pay the fee associated with the gift card purchase and obtain the rewards for the purchases.

In 2013, the couple managed to net $36,200 by their scheme and in 2014 they managed to parlay that knowledge into $277,275. When presenting the case to the court, the IRS ultimately attempted to reverse their longstanding policy under Rev. Rul. 76-96 that credit card rebates were not income. While the court agreed with the IRS in principle that the taxpayer did have an accension to wealth, the unnecessarily vague rules of credit card rebates left the court with no alternative but to rule for the taxpayer. Perhaps the future will see a change in the procedures of Rev. Rul. 76-96.

EXCLUSION OF LAWSUIT SETTLEMENTS

Legal settlements are often taxable and now thanks to the TCJA's suspension of 2% miscellaneous deductions, the associated legal fees are no longer deductible.

Generally, the following applies to legal settlements:

1. Awards for physical injury or sickness are tax-free and excludable from income.

2. Awards for wrongful incarceration are also excludable due to the PATH Act.

3. Awards in cases of unlawful discrimination, certain claims against the U.S. government or certain claims against primary plans that fail to provide payment while taxable are entitled to an above-the-line deduction for attorney's fees and court costs. [IRC Sec. 62(a)(20)] The deduction is limited to the extent of the settlement. It is reported on line 36 of Schedule 1 as an adjustment to income using the notation "UDC."

All other legal settlements are fully taxable. The full amount of the settlement without regard to legal fees is reported as "Other Income."

Emotional distress, mental anguish, and loss of reputation are not treated as a physical injury or physical sickness. This is due to a statutory change in 1996 [IRC Sec. 104(a)], as the courts continue to find this definition narrow. The legislative history of IRC Sec. 104 indicates that physical symptoms arising from emotional distress such as insomnia, headaches or stomach disorders are not physical injuries.

Five key rules of lawsuit settlements can help make that conversation easier to address, but not necessarily more favorable for the taxpayer recipient:

1. **Taxes are going to be based on the origin of the claim.** This principle is often referred to as the Cohen principle named after Justice G.A. Cohen. The initial "origin of the claim" concept was as a result of a Supreme Court case, Woodward v. Comm., and further expanded by United States v. Hilton Hotels. The purpose of the doctrine is to ensure that reason for the settlement was proximate to the cause for the claim to be paid.

2. **A recovery for physical injury and sickness is tax-free; however, a symptom of emotional distress *is not* considered to be a physical injury.** It is critically important that the tax details be addressed prior to signing on the dotted line. Postmortem tax planning for lawsuits is almost always detrimental, especially when language in the settlement agreement has verbiage that has no reference to physical injury.

3. **Most lawsuits involve multiple issues.** The plaintiff and defendant should agree on the tax treatment. Seldom will the IRS ignore these types of agreements.

EXAMPLE: Award from lawsuit involving multiple issues

The employer was not responsive to the worker's requests for accommodations to address their prior disability. As a result, he missed work. However, the continual harassment by the employer resulted in a manifestation of both physical illness, which continues to plague the taxpayer, and mental anguish. The Americans with Disabilities Act (ADA) prohibits the failure of the employer to make "reasonable accommodations" to the worker.

As a result of these issues, the worker settled for $200,000. It should be recognized that the $200,000 contained funds for lost wages in the amount of $50,000, a taxable award, that should find itself onto Form W-2, not Form 1099-MISC. In addition, the payment contains ADA failures, mental anguish, and physical injuries. A "reasonable" allocation to physical injuries will reduce the taxability of the award.

An agreement that the physical injury award was worth $100,000, the mental anguish $25,000, and the punitive failure under ADA of $25,000 as part of the agreement would reduce the taxability of the award from $200,000 to $100,000. The IRS is not likely to ignore the allocation, and the taxpayer is thus able to reduce his tax bill by almost 50%.

4. **Attorney fees are a trap.** As a result of the TCJA, the only legal fees deductible for an award will be those as a result of discrimination claims, certain employment claims, and whistleblower awards. These awards qualify for legal fees above the line. There are exceptions when the legal fees are not paid to the taxpayer such as class action suits that legal fees are paid under separate court order, which can also occur. A growing trend is the court setting aside the fee agreement between the taxpayer and attorney and determining payment separately; however, expect the IRS to challenge these agreements.

5. **Punitive damages and interest are always taxable.** This can be a horrendous result when connected to a physical injury award.

COURT CASE: In the recent *Monsanto* case, the impact of the change brought by the TCJA become clear. In the settlement, the plaintiff was awarded $39 million in physical injury compensatory damages and $250 million in punitive damages. With court costs and attorney fees, it is estimated that he will receive about half of the total award, and all the punitive damages will be taxable. This will leave the taxpayer about $19.5 million plus $125 million. The tax bill for the IRS will be about $92.5 million and California will get about $30 million, leaving the taxpayer about $22 million.

Income Exclusion Cases and Statutes

COURT CASE: In the case of *Maciujec* (T.C. Summary Opinion 2017-49), the court affirmed a settlement payment must have direct connection to the physical injury. In settlement, the payments were labeled compensatory damage payments. A 1099-MISC prepared by the employer was delivered to the preparer but excluded as a "sexual abuse injury" payment. A simple reading of the settlement agreement by the practitioner would have avoided this outcome.

NEW COURT CASE: In *Doyle*, T.C. Memo 2019-8 the taxpayer settled with his employer for alleged "back wages" and alleged "emotional distress" despite the fact that numerous physical illnesses as a result of the discharged prompted him to initiate the suit. The court "stated that it has noted the "crumbling barrier between psychiatry and neurology." He signed the settlement agreement that stipulated his mental condition without advice of counsel. While the court found validity in the taxpayer's portrayal of physical illness, they were not willing to overturn the settlement agreement.

OBSERVATION: The *Doyle* case appears to be one of the most compelling cases heard by the court which attempted to move the physical injury into the mental realm. In the final analysis, it appears the settlement agreement ruled the day, and the court was not willing to throw the settlement out. Counseling the client of the need to review the tax implications of any settlement can save the day.

COURT CASE: In *Blum* (TC Memo 2021-18), the taxpayer sued her attorney as a result of the attorney's unsuccessful representation in a medical malpractice suit. The taxpayer successfully convinced the court that, except for her attorney's breach of the standard of care, she would have prevailed in her medical malpractice suit. Ultimately the court awarded the taxpayer $125,000 as a result of the malpractice suit. Her settlement agreement with the law firm provided that she did not sustain any physical injuries as a result of her malpractice lawsuit. However, Ms. Blum excluded the proceeds of the suit from income as being the result of physical injury. Predictably, the Tax Court did not find a proximate relationship between Ms. Blum's purported injuries and the settlement of the malpractice suit, and the $125,000 was therefore taxable income.

COURT CASE: In *Blackwood* (T.C. Memo 2012-190), a long-suffering victim of depression was dismissed by her employer. After the termination, her depression relapsed, causing her to experience severe insomnia, migraines, nausea, vomiting, weight gain, acne, and back issues. On advice of counsel, she excluded the award, but the origin of claim once again found for the IRS.

OTHER TYPES OF EXCLUDABLE INCOME

Other types of excludable income include—

1. Gifts and inheritances (unless income with respect to decedent, such as IRA, or pension distributions).

2. Life insurance proceeds.

3. Disaster relief payments (IRC Sec. 139).

4. Most public welfare benefits, economic recovery, and mortgage assistance.

COURT CASE: Veterans benefits for a service-related disability are tax-free under IRC Sec. 104(b)(2)(D). These payments are typically direct from the VA based on a percentage of disability, but though the taxpayer believed he qualified, never applied for them. In *Keeter* (T.C. Summary Opinion 2017-36), a veteran received an annual benefit which he excluded from income as a service-related disability payment. The IRS disagreed, assessing taxes on the payment. In its decision the Tax Court found that the taxpayer did qualify, based on the record, for disability benefits, allowing the exclusion under IRC Sec. 104(b)(2)(D).

QUALIFIED DISASTER RELIEF PAYMENTS

A Qualified Disaster Relief (QDR) payment is not an item of gross income. A *QDR* is a payment that results from:

1. A terroristic or military action,
2. A federally declared disaster,
3. A disaster resulting from an accident involving a common carrier, or
4. Any other event determined by the IRS to be of a catastrophic nature.

A QDR includes payments by a federal, state, or local government, or an agency or instrumentality of those governments, a disaster determined by the appropriate governmental authority (as determined by the IRS) to warrant assistance from the governmental authority. These payments include:

1. Any payment that was paid the taxpayer to pay reasonable and necessary personal family, living or funeral expenses associated with a disaster, or
2. To reimburse or pay reasonable and necessary expenses to repair or rehabilitate a personal residence (including a rented residence) or repair or replace its contents, or
3. By a person who provides or sells transportation as a common carrier because of death or personal physical injuries due to a qualified disaster, or
4. If the amount is paid by a federal, state, or local government, or an agency or instrumentality of those governments, in connection with a qualified disaster to promote general welfare (but not if payments are made to businesses or for income replacement or unemployment compensation), or
5. Payments which are made to mitigate or avoid the effects of future disasters.

PAYMENTS FOR IN-HOME SUPPORTIVE CARE

IRC Sec. 131(a) provides for an exclusion for “qualified foster care” payments which provides for “difficulty of care payments.” An excludable qualified foster care payment must meet two tests:

1. Payments are made by a state or political subdivision of a state, or a qualified foster care placement agency, and

2. Is paid to the foster care provider for caring for a qualified foster individual in the foster care provider's home or as a difficulty of care payment [IRC Sec. 131(b)(1)].

The definition for a *qualified foster individual* is any individual who is living in a foster family home in which the individual has been placed by a qualifying organization [IRC Sec. 131(b)(2)].

To be a *difficulty of care* payment, the foster care individual must require additional care due to a physical, mental, or emotional handicap. The care must be performed in the payment recipient's home and the payment must be so designated by the qualifying state agency.

Notice 2014-7 provides information on qualified Medicaid payments and Community-based waiver program payments. In the notice, the IRS delineated that the care was a substitute for what would otherwise occur in a hospital, nursing facility, or intermediate care facility. PLR 201623003 and other guidance is available from the IRS at **www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income**. The site provides circumstances in which payments to an employee are excludable from income:

When the payments are made to an individual who is in fact an employee by the qualifying agency, the payments are subject to Social Security and Medicare withholding but are not taxable.

These payments would continue to be income tax excludable if the care provider's home is provided by the care recipient. (See the Q&A available on the IRS's website.)

REFUNDS OF ITEMIZED DEDUCTIONS (THE TAX BENEFIT RULE)

The general rule is that the refund is reported as income in the year received if claimed as an itemized deduction in a previous year. This is prevalent with state and local tax refunds, medical expense reimbursements, and casualty loss insurance reimbursements. The question is whether the deduction provided a tax benefit in the prior year [IRC Sec. 111(a)].

There are five prior-year events that limit the prior-year sales and local tax deduction, and hence limit the amount of income to report in the subsequent year:

1. Standard Deduction:

    a. No income is reported if the prior-year standard deduction exceeds the itemized deduction.

    b. The income may also be limited to the amount the itemized deduction exceeded the standard deduction in the prior year.

2. Alternative Minimum Tax (AMT):

    a. State and local taxes are not deductible once AMT takes effect.

    b. If AMT applied in the prior year, then the state tax deduction was not fully utilized. The following year's refund should be partially or fully excluded from income.

3. Refund of taxes paid in more than one year:

   a. Prorated state and local estimates and extension payments paid in more than one year between the two years.

   b. The proration should be made between each state and local refund.

   c. The prior year payments will reduce Form 1040 (2018), Schedule 1, line 10, income.

   d. The current year payments will reduce current year state and local taxes deducted on Form 1040, Schedule A.

4. Sales tax

   a. State and local tax refunds are not taxable if sales tax, not income tax, was used for the itemized deduction in the prior year.

   b. The income may also be limited to the amount the income tax exceeded the sales tax in the prior year.

5. IRC Sec. 164(b)(6) limits the refund of state or local taxes (SALT) to $5,000 for single filers ($10,000 for MFJ). Guidance on how to treat this limitation was provided by the IRS in Rev. Rul. 2019-11. The taxability of that refund will be determined based on the tax benefit rule.

EXAMPLE: Refund of state income taxes

Ben received a $750 refund of state income taxes paid in 2019. Had he paid only the proper amount of state income tax in 2020, his state and local tax deduction would have remained the same ($10,000) and his itemized deductions would have remained the same ($15,000). Ben received no tax benefit from the overpayment of $750 in state income tax in 2020. Thus, he is not required to include the $750 state income tax refund in his gross income in 2021.

Observation: The $750 refund was not taxable due to the tax benefit rule. There was not additional deduction due to the larger payment.

INCOME REPAID BY THE TAXPAYER

A taxpayer can find themselves in the position of repaying an “income benefit.” This can include, but is not limited to wages, unemployment compensation, pension benefits, or social security:

1. If the repayment occurred in the year of payment, the amounts of income and repayment are simply netted. Normally the payer of the income will have done this for the taxpayer, such as unemployment repaid in the year received will be netted on Form 1099-G, or

2. Social Security will normally offset payments in the current year and net the income amounts on Form 1099-SSA. In this case, there will be no benefit payments until the overpayment is completely repaid. The beneficiary can elect to repay the SSA in a single lump sum by applying the rules in Section B.

Overpayments greater than $3,000 from prior years that were repaid in the current year are calculated as—

1. Other itemized deduction on Schedule A, Line 16, or

2. A current year credit with the annotation "IRC Sec. 1341," based on the difference in tax in the year originally received (IRS Pub. 525). This will be reported on Form 1040, Schedule 3, Part I Nonrefundable Credits, Line 6(c).

GAMBLING INCOME

Casual versus Professional Gamblers

Most gamblers are considered casual gamblers or nonprofessional gamblers. According to the Supreme Court, a professional gambler is an individual who pursues gambling fulltime, with regularity, and as a livelihood rather than as a hobby. Professional gamblers must demonstrate a profit motive for it to be considered a trade or business. The following court cases have focused on whether the taxpayer was a professional gambler.

Zaleslak v. Comm.

The court was asked in *Zaleslak* (T.C. Summary 2019-16) to determine if the taxpayer was a professional gambler. For about two years the taxpayer's only source of income was his gambling winnings. The taxpayer then took off some time from his gambling activities to establish an alternative source of income. After a couple years as manager of a construction company the taxpayer began playing poker on weekends and in the evening. When work was busy, he discontinued his poker play. When work was slower, he played poker "full time." The court determined that Mr. Zaleslak lacked the necessary profit motive based on the factors listed in Reg. §1.183-2(b). In its final observation the court found that the taxpayer's full attention on weekends and evenings did not raise him to the level of a professional gambler.

Estate of John F. Chow, et al.

In a high-dollar decision, the taxpayer spouse attempted to deduct a $2.5 million loss from gambling on Schedule C in just one year. The Tax Court ruled the excess losses were not deductible and that professional gambler status had not been established. (*Estate of John F. Chow, et al.*, T.C. Memo 2014-49)

Michael N. Merkin, et ux. v. Comm.

Another case dealt with poor recordkeeping when a taxpayer attempted to transfer the recordkeeping requirement to the casino with his player's card. Like any other taxpayer, a gambler has the burden of proving that his/her activities rise to the level of a trade or business. It should be noted even the casinos consider these statements unreliable. (*Michael N. Merkin, et ux. v. Comm.*, T.C. Memo 2008-146)

The advice given by the Chief Counsel's office in EMISC (Electronic Miscellaneous Document) 2008-011 has given the casual gambler a primer on how to determine gains and losses from slot play. Under IRC Sec. 165(d), the concept of each separate wager being a transaction was at issue. The court ruled that measuring each wager (i.e., each "pull") was "unduly burdensome and unreasonable."

EXAMPLE: Treatment of wagering losses and gains

Linda went to a casino to play the slot machines on 10 separate occasions throughout the year. On each visit, she exchanged $100 of cash for $100 in slot machine tokens and used the tokens to gamble. She did not use cash, credit, or "player's cards" to gamble. On five occasions, she lost her entire $100 in tokens. On the other five occasions, her returned home with $20, $70, $150, $200, and $300.

For the year, Linda had total wagering gains of $350 ($50 + $100 + $200) and total wagering losses of $610 ($500 from losing the entire basis of $100 on five occasions + $80 + $30 from two other occasions). Her wagering losses exceeded her wagering gains for the tax year by $260 ($610 − $350). She must report the $350 of wagering gains as gross income. However, under IRC Sec. 165(d), she may deduct only $350 of the $610 wagering losses and cannot carry over the excess wagering losses to offset wagering gains in another tax year or offset non-wagering income.

The Chief Counsel's office stated that in looking at the casual gambler, "fluctuating wins and losses left in play are not accessions to wealth until the player redeems his tokens and can definitively calculate [. . .] the amount above or below basis [the wager] realized."

Accordingly, the casual gambler will look at their net activity on a day-by-day basis.

Reg §1.165-10

If taxpayers file a joint return, their gambling gains and losses are pooled so that the losses of one spouse are deductible against the gains of the other. While the advice memorandum does not completely relieve taxpayers of the difficult recordkeeping requirements of their gambling activities, it is significantly more guidance than taxpayers have had in the past regarding these types of activities.

Recordkeeping

Unlike other deductions, losses from gambling are somewhat difficult to substantiate. The IRS has stated that, to adequately substantiate gambling losses, taxpayers should keep an accurate diary or similar record, supplemented with supporting evidence. In addition, the IRS requires the date and type of wager, name of establishment, address of establishment, and the names of other persons present.

The IRS wants backup data to the diary such as Forms W-2G, wagering tickets or receipts, cancelled checks, credit card records showing cash withdrawals or cash advances, direct bank withdrawals, and receipts provided by the casino (*Moore v. Comm.*, T.C. Memo 2011-173).

A recent court case has given some glimmer of hope to taxpayers who have failed to keep appropriate records.

COURT CASES: The courts have generally refused to allow taxpayers to invoke the *Cohan* rule regarding missing gambling records. Peter Phuong K. Pham and his spouse were denied the use of the *Cohan* rule when they failed to maintain adequate records (*Pham*, T.C. Summary Opinion 2016-73). When the taxpayers indicated that the requirement was too onerous for contemporaneous records, the court found their argument was without merit.

However, in *Coleman* (T.C. Memo 2020-146), the court examined the taxpayer's financial records, his modest lifestyle, and the expert witness's report as evidence of his gambling losses. The court determined that Mr. Coleman provided sufficient evidence to substantiate a deduction for gambling losses of at least his $350,241 in gambling winnings. The court found that credible testimony and financial records indicated that Coleman used account withdrawals and other income for gambling. In addition, the court saw no evidence of an increase in net worth from the winnings or changes in the taxpayer's lifestyle.

Gambling Winnings and Losses

Taxpayers must pay income taxes on all gambling winnings, regardless of whether the winnings are reported on Form W-2G:

1. The *casual gambler* reports all gambling winnings as ordinary income. These winnings are not subject to self-employment tax.

2. The *professional gambler* reports gambling winnings and ordinary and necessary expenses on Schedule C.

Gambling losses *cannot* exceed gambling winnings, even for a professional gambler.

EXAMPLE: Treatment of gambling winnings, losses, and expenses

The taxpayer, a professional gambler during the year wins $5 million. His losses were $4.7 million. During the tax year he incurred expenses as follows: travel $100,000, lodging $200,000, entry fees $100,000, and meals $50,000, for a total of $450,000. The taxpayer will report the entire amount of the winnings on Schedule C, but his travel, entry fees, and meals deduction will be limited to no more than $300,000.

As inducements to patronize casinos, owners frequently give customers complimentary goods and services—or *comps*. All comps—e.g., airfare, use of autos, lodging, shows, gifts, and meals—are also considered gambling winnings (*Libutti v. Comm.*, T.C. Memo 1996-108).

Substantiated gambling losses to the extent of winnings are deductible as a miscellaneous deduction, but are not subject to the 2%-of-AGI rule and are fully allowed for AMT.

Most states that have a state income tax include gambling winnings as taxable income. Some states do not allow deductions for casual gambling losses, several states do not allow a deduction for losses, and a few states do not allow a refund of the state income tax withheld for nonresidents.

PLANNING TIP: Removing funds from the ATM at the gambling establishment and redepositing them when the session is finished can be an excellent way of maintaining gains and loss records.

Gambling winnings are reported, and any federal income tax withheld, on Form W-2G. Gambling winnings are reported on W-2G if winnings are $1,200 or more from a bingo game or slot machine; $1,500 or more from a keno game; or $5,000 from a poker tournament. The payer may be required to withhold 24% (2018) (regular or backup) of gambling winnings for federal income tax.

Sports Betting

COURT CASE: In 2018, the Supreme Court struck down a federal law called the Professional and Amateur Sports Protection Act (PASPA). PASPA prohibited states that did not already permit sports gambling from doing so. At the time, Nevada was the only state that permitted sports gambling. This change will open the door for all states to offer sports gambling (*Philip D Murphy, Governor of New Jersey, et al v. NCAA, et al*, No. 16-476, Supreme Court, May 14, 2018).

When the bet is placed through a website, the reporting threshold for Form W2-G is $600. If payments are being made by a third party such as PayPal, the reporting will be on Form 1099-K. The amounts will be governed by the 200 transactions and/or $20,000 payment rule.

PLANNING TIP: Reporting for the Fantasy Sports betting will be netted. For example, assume that during the year a taxpayer had gross winnings of $20,000 plus a $5,000 bonus based on activity. There was a $1,000 fee for entry. Most reporting will indicate $24,000 in winnings, not the gross amount of $25,000.

Winnings from these activities can be reduced by losses on other gambling activities. In the past, many Fantasy sports organizers were not considered gambling activities in some states. However, more states are revising state law to consider them gambling.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 525, *Taxable and Nontaxable Income*

CHAPTER 2: DEBT FORGIVENESS AND FORECLOSURES

Learning Objectives

Completion of this chapter will enable participants to—

- Determine if debt forgiveness results in taxable income and calculate the gain or loss on foreclosed property.
- Calculate excludable income and reductions in tax attributes if required.

WHAT'S NEW

1. The Taxpayer Certainty and Disaster Tax Relief Act of 2020 extended the Qualified Principal Residence Indebtedness provision through December 31, 2025. In addition, it also reduced the qualifying indebtedness limit.
2. Additional relief for COVID related loans including SBA subsidized payments.
3. Discussion on Eviction and Foreclosure Moratoriums
4. Revised Overview of Debt Forgiveness

TAXATION OF COVID RELATED RELIEF.

The COVID-related Tax Relief Act of 2020 (COVIDTRA), which was part of the Consolidated Appropriations Act of 2021 (CAA of 21), provided additional exceptions for debt cancellations related to COVID relief.

1. Paycheck Protection Plan (PPP) Loan Forgiveness. COVIDTRA provides that for tax years ending after March 27, 2020, no amount is included in the gross income of the eligible recipient by reason of the PPP loan forgiveness. This treatment applies to both first and second draw loans. (Please see Chapter 26 for more information concerning the relief and deduction of related expenses.)
2. Economic Injury Disaster Loan (EIDL) Grants. COVIDTRA provides that an EIDL advance or grant is not includable in the income of the recipient. (Please see Chapter 26 for more information concerning the relief.)
3. Small Business Administration (SBA) Subsidized Payments. Under this program, the SBA made loan payments including principal, interest, and any fees. COVIDTRA provides that these payments are not includable in the income of the recipient.
4. Educational Loans. A discussion of the expanded debt forgiveness relief relating to student loans can be found in Chapter 6.

Section 279 of COVIDTRA granted Treasury and the IRS authority to waive the filing requirement for information returns and payee statements related to COVID relief. In Notice 2021-6, the IRS waived the filing requirements for this relief.

OVERVIEW OF DEBT FORGIVENESS

Forgiveness or cancellation of debt occurs when a debtor repays less than the value of an undisputed debt and is forgiven for any remainder.

The forgiveness occurs when a portion or all of the debt is forgiven by the lender or by a function of law. This is referred to as the identifiable event. Understanding, state law is critical. The author has used the following websites for primers when dealing with out of state clients:

1. United States Foreclosure Laws (**http://foreclosurelaw.org**) provides a great summary of the foreclosure laws and timelines in every state.

2. Nolo has a summary of the statutes of limitations by states available at **www.nolo.com/legal-encyclopedia/statute-of-limitations-state-laws-chart-29941.html**

To make an income tax determination, the practitioner must determine (1) who is the true borrower, (2) the use of the loan proceeds, and (3) the identifying event triggering the forgiveness.

The following should be determined:

1. **The Borrower:** Who is the true borrower? Often, there is a question of who is responsible for the debt. Is the debt owed by a single spouse or is it a joint liability?

   a. Business clients are not always certain if the loan was made personally or to the business.

   b. While true borrowers can have forgiveness of debt income, guarantors/co-signors cannot since they never personally benefited from the borrowing.

   c. Obtaining copies of loan documents and obtaining legal advice is often advisable.

2. **Use of the Funds:** What were the funds used for? Were the funds used for a personal, investment or business purpose? Forgiveness related to the taxpayer's trade or business is reported differently than personal borrowing. Furthermore, the exceptions for forgiveness income related to business and non-business debt differ.

3. **Validity of the Debt:** Is this a valid debt or is the debt in dispute? The courts have defined indebtedness as an obligation that is absolute and not contingent. Accordingly, cancellation cannot take place when the debtor has a legitimate dispute with a vendor over the amount of the debt. Often creditors will issue Form 1099-C with incorrect or inflated amounts that should be disputed.

4. **Identifiable Event:** What is the identifiable event and is the debt legally collectible? The identifiable event fixes the loss with certainty and indicates the time the debt was discharged. A debt can be discharged by the creditor or a function of state law. All states have statutes limiting the period of collection. Once the statute has expired, the debt is no longer valid and not legally collectible. Often Form 1099-C is issued in a year after the statute for collections has expired. If by statute a debt expired in 2000, there is no right to collect in later years.

5. **Whether the Loan Is Recourse or Nonrecourse:** The type of debt is important when the lender takes possession of the property and forgives the debt as part of a foreclosure, repossession, deed in lieu of foreclosure, or short sale. This is discussed further later in this chapter.

Once the transaction(s) is understood, the debt forgiveness should be recalculated. Often the Form 1099-C is issued in the name of the wrong taxpayer, overstates the discharge, contains disputed amounts and fees not allowable under the contract or is issued in the wrong year. If the issuer will not correct the form, attach a statement on the return listing all the Form(s) 1099-C received and adjust to the correct forgiveness amount. Provide the justification for the reduction as part of the statement.

NOTE: As part of the taxpayer bill of rights, IRC Sec. 6201(d) provides protection for a taxpayer disputing any item of income with respect to information returns filed with IRS. If the taxpayer fully cooperates and within a reasonable period of time provides access to all information and documents, the IRS has the burden of producing reasonable and probative information concerning such deficiency. A taxpayer receiving an incorrect Form 1099 should make their position clear in the first contact with IRS. If the taxpayer is unable to resolve the issue the taxpayer should assert IRC Sec. 6201(d) when filing a petition with the Tax Court.

COURT CASE: In *Hernandez, Jr.*, a Tax Court decision denying *pro se* the married taxpayers' motion to shift burden of proof regarding disputed unreported cancellation of debt income to the IRS because of its underlying deficiency determination of naked assessment, was affirmed. Any allegations of misconduct of the IRS during taxpayers' exam were unsubstantiated and in any event, the IRS didn't rely solely on Form 1099-C as evidence of their unreported income, but rather procured a follow-up affidavit from the issuing bank attesting to the form's veracity, then matched the debt to a credit card loan in the husband's name, and further produced an account statement verifying that the loan balance at the time the debt was allegedly cancelled was equal to or greater than the amount cancelled. Also, aside from their original Form 1040, taxpayers refused to produce any contrary evidence, including a specific denial that the debt had been cancelled. (*Hernandez, Jr. v. Comm.*, CA 5, 126 AFTR 2d ¶2020-5111)

Next determine if the taxpayer meets any of the exceptions to income recognition. To the extent the taxpayer meets an exception, the amount to be excluded from income is included on Form 982, line 2. Total amount of discharged indebtedness excluded from gross income. The reason for the exclusion is checked on line 1. The exceptions to the general rule include:

1. Forgiveness or cancellation that takes place under Title 11 Bankruptcy.
2. Forgiveness or cancellation to the extent that a taxpayer was insolvent immediately before the cancellation.
3. Qualified farm debt indebtedness.
4. Qualified real property business indebtedness. See Gear Up's Helping Clients Through Challenging Times course for more information.
5. Qualified principal residence indebtedness.
6. Student loan forgiveness provisions including new COVID related relief. (See Chapter 6 for more information.)

Any remaining debt discharge is recognized as income on the tax return. Depending on the use of the funds, the remainder is recorded as one of the following:

1. Other income on line 8, Schedule 1, Form 1040 for discharge related to personal borrowings.

2. Schedule C or F Other income, if related to the taxpayer's trade or business.

3. Schedule E Rental Income, in the case of borrowings related to the taxpayer's rental property.

If the taxpayer meets an exception, they are required to reduce any tax attributes remaining as the last step in preparing their return. The attribute reduction requires taxpayers to offset the cancelled debt against NOLs, carryforward credits and basis of the assets. The taxpayer gets to use the available attributes prior to the attribute reduction. Accordingly, a taxpayer's NOL carryforward would offset current year income before the attribute reduction.

REVIEWING FORMS 1099-A AND 1099-C

Form 1099-A is used by the lender to indicate an acquisition of property in full or partial satisfaction of a debt. It could relate to a foreclosure, deed-in-lieu, or abandonment. The remaining debt (if any) may or may not be forgiven.

1. Box 1 is for the date the property legally transferred to the lender.

2. The outstanding principal on the date of the transfer goes in Box 2.

3. Box 4 is the fair market value (FMV) of the property; usually the gross foreclosure bid price but, if the property was abandoned or voluntarily conveyed to the lender, an appraised value is used.

4. Box 5 indicates whether the buyer was personally responsible for the debt. This impacts how the transaction is reported.

PLANNING TIP: Receipt of Form 1099-A does not indicate a debt was cancelled—it reports an exchange treated as a sale. Only if the lender forgives or by function of law the remainder is forgiven there is debt forgiveness. The lender who repossesses or takes title to the property still has the right to pursue any unpaid balance.

COURT CASE: In a suit a taxpayer brought against lenders for various harms incident to wrongful foreclosure of his and his ex-wife's home, the claim that he was improperly issued two Forms 1099-A that resulted in greater tax liability than he actually owed was dismissed. Notwithstanding the taxpayer's allegations regarding Forms 1099-A, he made no mention of Form 1099-C, which was the form that would show any cancellation of debt, dollar amount of same, and necessary information for filing Form 1040 and calculating his taxes, which in turn the taxpayer also didn't show or mention; thus, without same, his claim of incurring "increased" taxes was purely speculative and insufficient to survive the dismissal motion. (*Helmert V. Cenlar*, 123 AFTR 2nd, 2019-799).

If a lender acquires the property and the debt is forgiven in the same tax year, the lender can issue Form 1099-C (and is not required to issue 1099-A). Form 1099-C reports similar information but also indicates the amount of debt forgiven and the date canceled.

Deductible unpaid interest is not required to be reported. However, most entities will issue the 1099-C including all unpaid interest in both box 2. Amount of the Debt Discharge and in box 3. Interest included in box 2. When making the COD income calculations, care should be made to remove the deductible interest amount.

No Form 1099-C is required when there is a release from a debt as a co-debtor or grantor. Any interest forgiven should appear in both Box 2 and Box 3 of Form 1099-C. If the interest *would not have been* deductible if paid (i.e., personal loan) and the taxpayer does not meet any other exception or exclusion, the Box 2 amount should be included in income. If the interest *would have been* deductible if paid, (e.g., business loan) and the taxpayers do not meet any other exception or exclusion, the COD income is the net result of the amount in Box 2 less the interest shown in Box 3. It is important to attach a statement to the return showing the calculation.

RECOURSE DEBT

A taxpayer is personally liable for recourse debt. In default, the borrower is accountable for the unpaid balance beyond the collateral pledged for the loan.

When a lender takes property in a foreclosure, deed in lieu, or as part of a short sale in satisfaction of a recourse note, the deemed sale price is the lesser of the FMV of the property at the time of foreclosure or the amount of secured debt.

If the debt exceeds FMV, the difference, if forgiven, is treated as COD income.

EXAMPLE: Treatment of forgiven debt amount exceeding FMV

Dean purchased a Florida vacation home for $300,000 with a 10% down payment; he financed the balance with a $270,000 recourse mortgage. He lost his job and moved to another company earning significantly less. The bank agreed to take back the property and forgive any balance due ($260,000) on the note. The FMV of the property, on the date relinquished, was $230,000.

Assuming Dean does not meet any of the exclusion provisions, he will recognize $30,000 COD income (the balance of the note $260,000 over the $230,00 FMV of the property) on his tax return and a $70,000 nondeductible loss on the deemed sale (the FMV sale price of $230,000 less his basis of $300,000).

Variation 1: The same fact pattern as above, except the property is worth $270,000 when the bank takes back the property. Dean will have no cancellation of debt since he will have paid $270,000 to settle a $260,000 liability. He will also have a nondeductible loss of $30,000.

Variation 2: The same facts as in the original Example, except the property is Dean's rental property. The transfer to the bank would be treated as a disposition which would allow Dean to deduct any carryforward passive losses associated with the property. He would recognize the $30,000 discharge income on Schedule E as it is associated with his rental property. In addition, his $70,000 loss would now be deductible.

Fair Market Value (FMV)

The bid price in a foreclosure sale is presumed to be the property's FMV unless there is clear and convincing proof to the contrary. The amount that banks bid for the property can be arbitrary. In situations where the taxpayer could be subject to income on debt discharge, it is advisable to obtain a contemporaneous appraisal on the property before the foreclosure.

A foreclosure on property involving recourse debt can result in both:

1. A gain or loss from the sale of property, and
2. Debt discharge income.

NOTE: Debt discharge income occurs in a foreclosure only if the lender or by function of law a portion or all of the deficiency is forgiven. If the lender continues to pursue the collection of the debt, there is no discharge unless the lender accepts less than the full amount on the deficiency or the statute of limitations on the debt expires.

NONRECOURSE DEBT

Nonrecourse debt is debt where the lender can only look to the loan collateral in the event there is a default on the loan. Some states restrict acquisition loans on principal residences to nonrecourse loans. The following states all have nonrecourse statutes: Alaska, Arizona, California, Hawaii, Minnesota, Montana, North Dakota, Oklahoma, Oregon, Washington, and Nevada.

In a foreclosure, deed in lieu, the sale proceeds from the deemed sale is equal to the balance of the nonrecourse debt. Accordingly, there is no debt forgiveness when the note is a nonrecourse note.

EXAMPLE: Treatment of a nonrecourse debt

Assume the same facts about Dean and his vacation home except the mortgage was nonrecourse; thus, he will not recognize COD income. He is deemed to have sold the property for $260,000 and has a $40,000 nondeductible loss on the sale.

Variation: Dean keeps the vacation home and is able to negotiate a $30,000 reduction in the amount of the loan. Even if the loan is nonrecourse, the fact that Dean is not required to repay the full amount of the borrowing will result in COD.

BANKRUPTCY

Bankrupt taxpayers exclude all debt discharged income from taxable gross income [IRC Sec. 108(a)(1)(A)]. *Bankrupt* means the discharge from debt occurred under the jurisdiction of the court in a Title 11 of the U.S. Bankruptcy Code. Title 11 of the U. S. Bankruptcy Code includes: Chapter 7 (Liquidation), Chapter 11 (Business Reorganization), Chapter 12 (Family Farmers and Fishermen), and Chapter 13 (Adjustment of an Individual’s Debts).

NOTE: In addition, there is Chapter 5 bankruptcy (a modified version of Chapter 11), which defines procedural guidelines for small debtors and creditors. It tends to be more expedient than a Chapter 11 reorganization. For a more detailed explanation of bankruptcy and tax practitioner issues, please see Gear Up’s *Helping Clients Through Challenging Times* manual.

Although bankrupt taxpayers do not recognize income on the discharge of debt, they are still required to reduce certain tax attributes [IRC Sec. 108(b)].

COURT CASE: A tax practitioner can be called upon to determine whether a certain income tax debt is dischargeable in bankruptcy. The general rule is that returns that were due more than three years prior to the bankruptcy filing date may be dischargeable. Not all taxes meeting the general rule are eligible to be discharged. In *Giacchi v. U.S.* [119 AFTR 2d 2017-1722 (CA 3)], the 3rd Circuit Court of Appeals sided with eight other Circuits; to be eligible for discharge under the bankruptcy code the return must be timely filed. A late filed return does not meet the requirements for a return under IRC Sec. 523(a)(1)(B) as required by Title 11 of the bankruptcy code.

COURT CASE: A bankruptcy court held that a taxpayer with attention deficit hyperactivity disorder (ADHD) who had trouble holding a job and had difficulty with his financial affairs who filed late returns and did not pay over $400,000 of taxes and interest did not willfully evade tax. The unpaid liability was dischargeable in bankruptcy. [*Clark* (Bktcy Ct GA 2/19/2019) 123 AFTR 2nd 2019-444]

CAUTION: Circular 230 specifically prohibits a tax practitioner from practicing law without a license. Tax practitioners should focus their advice on tax matters in bankruptcy. Establishing a relationship with a bankruptcy attorney will serve the client best and protect the practitioner from liability.

INSOLVENT TAXPAYERS

Taxpayers do not have to recognize COD income on debt for which they are personally liable to the extent they are insolvent immediately before discharge.

To determine insolvency, a taxpayer must include:

1. All assets, including exempt assets such as the value of pension plan and retirement accounts.

2. Liabilities, including the entire amount of recourse debts and the amount of nonrecourse debts that are not in excess of the FMV of the property that is security for the debts.

A spouse's separately owned assets can be excluded from the determination of the insolvent spouse's net worth, even if the couple files a joint return (PLR 8920019).

For contingent liabilities to be included, the taxpayer must be able to prove "it is more probable than not" that they will be called on to pay the liability.

NOTE: Numerous cases have centered on taxpayers who claimed COD income was not taxable due to the taxpayer's insolvency. However, when taxpayers provided no evidence other than their own uncorroborated testimony, the cases were rejected by the courts; the burden of proof is on the taxpayer. (*Fuller v. Comm.*, TC Summary Opinion 2009-91, and *Hakim v. Comm.*, TC Summary Opinion 2009-92)

This exclusion does not apply to qualified principal residence indebtedness unless the taxpayer elects to apply the insolvency exclusion.

The exclusion is reported on Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness) and by checking line 1b—Discharge of indebtedness to the extent insolvent (not in a Title 11 case). The total amount of discharge indebtedness excluded from gross income is included on line 2.

Since the insolvency calculation is calculated immediately before the discharge of the debt, obtaining timely documentation for the calculation is critical.

IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions and Abandonments, has a worksheet to calculate insolvency. For completeness consider calculating insolvency for married taxpayers both on a joint and separate basis.

Obtain a Copy of the Taxpayer's Credit Report

To ensure that all debts are included obtain a copy of a recent credit report. The source for a free copy of an individual's credit report is **www.annualcreditreport.com**.

COURT CASE: In *Scheiber*, the IRS submitted the theory that the present value of a right to receive a retirement benefit was an asset that should be included in the insolvency calculation. The taxpayer brought the issue before the court, which ruled that since the taxpayer could not convert the right to receive the retirement income into a lump sum or convert the benefit to cash, it was not an asset for purposes of the insolvency calculation. (*Schieber v. Comm.*, TC Memo 2017-32)

NEW AOD: In Action on Decision 2021-01, the IRS announced that it will not acquiesce to the Tax Court's holding in *Schieber* (TC Memo 2017-32) that a taxpayer's interest in his employer's defined benefit pension plan—with respect to which his only right was to receive monthly payments—was not an asset for purposes of determining whether he was insolvent under IRC Sec. 108's exclusion for cancellation of debt income (CODI) for insolvent taxpayers.

EXAMPLE: Treatment of debt forgiveness when insolvency exceeds amount forgiven

Marta was able to negotiate a $5,000 reduction in her credit card debt. She received a Form 1099-C from the lender showing a $5,000 cancellation of debt. Immediately before the cancellation, Marta's total assets were $7,000 and total liabilities were $15,000; she was insolvent to the extent of $8,000. Since the amount of her insolvency immediately before the forgiveness is more than the amount forgiven, she can exclude the entire $5,000 in forgiveness from income on Form 982.

Variation: Marta's total assets immediately before the forgiveness were $13,000; thus, she was insolvent by $2,000. Marta would be entitled to exclude up to $2,000 of the COD on Form 982. The remaining portion of the forgiveness ($3,000) should be included in the "Other income" line of Schedule 1 of Form 1040.

CAUTION: Nonrecourse debt can sometimes have detrimental tax consequences for the insolvent or bankrupt taxpayer who is otherwise able to exclude debt discharge income.

EXAMPLE: Treatment of mortgage debt forgiveness

Harry owns rental property. Harry loses the property in foreclosure when the FMV is $350,000 and the balance on his note is $500,000. His basis in the property is $375,000. At the time of the sale, Harry is insolvent by $400,000.

If the mortgage is a recourse note, the deemed sales price for the property is the FMV ($350,000), which is less than his basis. If the bank forgives the note, Harry has COD income of $150,000. If insolvent, he could avoid taxation on the entire $150,000, and potentially have a loss of $25,000 on the sale of the property.

If he had a nonrecourse note, the FMV of the property would be disregarded; the deemed sales price is the full amount due on the note ($500,000). Although insolvent, Harry will recognize a $125,000 gain on the sale of the property.

NOTE: If the state foreclosure process includes the "right of redemption", any gain or loss related to the property transfer is not realized until the redemption period expires.

SPECIAL RULES FOR PRINCIPAL RESIDENCE DEBT

LAW CHANGE ALERT: The Taxpayer Certainty and Disaster Relief Act of 2020 (2020 Disaster Act) which was part of the CAA 21, extended the exclusion from gross income for the discharge of qualified principal residence indebtedness to include discharges before January 1, 2026. Previously, this exclusion expired on December 31, 2020. The Act also reduced the maximum acquisition amount indebtedness limits to $750,000 and $375,000 (MFS).

IRC Sec. 108(a)(1)(E), as amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (2019 Disaster Act) retroactively extended the exclusion back to 2018 and 2019. Taxpayers may find it beneficial to amend their 2018 and 2019 tax returns if they previously recognized income on the discharge.

Taxpayers can exclude from gross income a discharge (in whole or in part) of qualified principal residence indebtedness before January 1, 2026 [IRC Sec. 108(a)(1)(E)(i)].

The exclusion applies where taxpayers restructure their acquisition debt on a principal residence, lose their principal residence in a foreclosure, or sell a principal residence in a short sale (where the sales proceeds are insufficient to pay off the mortgage and the lender cancels the balance).

But the exclusion does not apply if the discharge is on account of services performed for the lender (for example, an employee of the lender and the discharge relates to employment services performed) or any other factor not directly related to a decline in the value of the residence or to the taxpayer's financial condition [IRC Sec. 108(h)(3)].

The exclusion also does not apply to a taxpayer in a Title 11 bankruptcy case; the regular Title 11 bankruptcy exclusion applies [IRC Sec. 108(a)(2)(A)]. Insolvent taxpayers other than those in a Title 11 bankruptcy case can elect to not have this special exclusion apply and instead rely on the Section 108(a)(1)(B) rules for insolvent taxpayers [IRC Sec. 108(a)(2)(C)]. The exclusion *does apply* when taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure.

Qualified principal residence indebtedness is debt that:

1. Meets the definition of *acquisition indebtedness* for the residential interest expense rule [IRC Sec. 162(h)(3)(B)].
2. Applies to the principal residence (excludes second or vacation homes).
3. Is limited to $750,000 on the aggregate amount of debt that can be treated as qualified principal residence indebtedness. (**Note:** MFS limit is $375,000.). This amount was reduced by the 2020 Disaster Act from its previous $2 million/$1 million limit.

Ordering Rule

If only a part of the loan is qualified principal residence indebtedness, the exclusion from income only applies to the extent that the amount cancelled exceeds the amount of the loan (immediately before the cancellation) that is not qualified principal residence indebtedness.

The effect of this rule is the application of any forgiveness first to nonqualified debt. Accordingly, those taxpayers who refinanced their home for purposes other than buying, building and improving the property may be subject to income on the loss of the home.

EXAMPLE: Treatment of discharged debt under the ordering rule

Sheri incurred recourse debt of $800,000 when she purchased her principal residence for $880,000. When the value of the property was $1 million, she refinanced the property for $850,000. At the time, the original mortgage had a balance of $740,000. Sheri used the $110,000 to pay off credit card debt.

Two years later she lost her job, and her property had declined in value to an amount between $700,000 and $750,000. The lender agrees to a short sale of the property for $735,000 and to forgive the remaining balance on the note of $115,000.

Under the ordering rule, Sheri can only exclude $5,000 under the exclusion for canceled qualified principal residence indebtedness ($115,000 canceled, minus $110,000 amount of indebtedness that is not qualified principal residence indebtedness). Sheri must include the remaining $110,000 of canceled debt income on Schedule 1 of Form 1040, unless another exception or exclusion applies.

OBSERVATION: If a taxpayer such as Sherry in the previous example was insolvent, she should consider electing out of the principal residence indebtedness and should consider the insolvency exception.

Reduction of Tax Attributes

If the taxpayer excludes cancelled qualified principal residence indebtedness from income and continues to own the home after the cancellation, he must reduce the basis of the residence by the amount excluded from income. This is reported on line 10b of Form 982.

The exclusion does not apply to taxpayers in bankruptcy [IRC Sec. 108(h)(3)]. An insolvent taxpayer can elect to not have the mortgage forgiveness exclusion apply, and therefore rely on the exclusion for insolvent taxpayers.

NEW COURT CASE: In *Weiderman*, *a*n Mr. and Mrs. Weiderman were found to have taxable COD income as a result of her former employer's discharge of an unrepaid portion of a loan the employer made to help the taxpayers purchase a new home. The Weiderman's argument to exclude the COD pursuant to IRC Sec. 108(a)(1)(E)'s provision for qualified principal residence indebtedness—as defined in turn as *acquisition indebtedness* within the meaning of IRC Sec. 163(h)(3)(B)(i)—failed in the face of evidence that their indebtedness didn't qualify thereunder. Evidence included that the initial promissory note did not provide that the indebtedness was secured by their residence and that the note wasn't recorded. While taxpayers later signed another note in connection with her employment termination, such wasn't "incurred in acquiring, constructing, or substantially improving" their residence. [*Mark Weiderman, et ux. v. Comm.*, (2020) TC Memo 2020-109]

FORBEARANCE AND LOAN MODIFICATION

NEW FORBEARANCE PROGRAMS: Certain taxpayers who have financial difficulties due to the current coronavirus economy may be eligible to request forbearance from foreclosure on their residence [Sec. 4022 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)].

To be eligible, the mortgage must be a federally backed mortgage loan insured by the Federal Housing Administration; insured under section 255 of the National Housing Act; guaranteed under section 184 or 184A of the Housing and Community Development Act of 1992; guaranteed or insured by the Department of Veterans Affairs; guaranteed, insured, or made by the Department of Agriculture; or purchased or securitized by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association. The borrower must be experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency.

The borrower must submit a request to the borrower's servicer and affirm that they are adversely affected by the COVID-19 emergency. The forbearance shall last for 180 days and may be extended an additional 180 days, although the borrower may request a shortened period.

During forbearance, no additional fees, penalties, or interest may be charged beyond the interest that would have been charged if the borrower made all payments in a timely manner. Currently, the deadline for requesting initial forbearance is September 30, 2021. For more information, visit **www.consumerfinance.gov/coronavirus/mortgage-and-housing-assistance/help-for-homeowners/learn-about-forbearance**.

MORITORIUM ON EVICTIONS AND FORECLOSURES: The federal foreclosure moratorium ended on July 30, 2021. The Federal Housing Administration (FHA) announced on July 30, 2021 that it is extending its moratorium through September 30, 2021. Besides the federal program, many states have also provided moratoriums on foreclosure. An eviction and foreclosure tracker is available at **www.perkinscoie.com/en/news-insights/covid-19-related-eviction-and-foreclosure-ordersguidance-50-state-tracker.html**.

The Center for Disease Control and Prevention (CDC) announced on August 3, 2021 that it would extend the federal eviction moratorium though October 3, 2021.

Loan Modification

While a reduction in the principal balance of a loan results in the discharge of indebtedness, a modification of the loan terms (interest rate, repayment schedule) does not always result in the cancellation of debt.

As long as the debt balance is equal to the old debt and the new interest rate exceeds or equals the AFR and is paid at least annually, the modification does not result in cancellation of debt income.

REDUCTION OF TAX ATTRIBUTES

If the canceled debt is excluded by reason of bankruptcy or insolvency, the taxpayer must use the excluded debt to reduce (dollar for dollar, except for the credits which are reduced by 33⅓¢ for each dollar) the following tax attributes (but not below zero) in the order listed (the reduction is made after figuring the tax liability for the current year):

1. **Net Operating Loss (NOL).** First reduce any current year NOL and then reduce any NOL carryover in the order of the tax years from which the carryovers arose, starting with the earliest year.

2. **General Business Credit Carryover.** Reduce the credit carryover to/from the year of discharge. Reduce the credit carryovers to the current year in the order in which they are taken into account.

3. **Minimum Tax Credit.** Reduce the minimum tax credit available for the following year by 33⅓¢ for each dollar of excluded cancelled debt.

4. **Capital Loss.** First reduce any current year net capital loss and then any capital loss carryover. This is a dollar-for-dollar reduction.

5. **Basis.** Reduce the basis of the property held as of the beginning of the following year in the following order and within each category, in proportion to the adjusted basis.

    a. Real property (except inventory) used in the taxpayer’s trade or business or held for investment that secured the canceled debt.

    b. Personal property (except inventory, accounts and notes receivable) used in the taxpayer’s trade or business or held for investment that secured the canceled debt.

    c. Other property (except inventory, accounts and notes receivable, and real property held primarily for sale to customer) used in the taxpayer’s trade or business or held for investment.

    d. Inventory, accounts and notes receivable and real property held primarily for sale to customers.

    e. Personal use property; this includes property not used in trade or business nor held for investment.

NOTE: When using the standard order, basis cannot be reduced below the aggregate of the taxpayer’s liabilities immediately after the discharge [IRC Sec. 1017(b)(2)].

6. **Passive Activity Loss and Credit Carryovers.** Loss carryovers are reduced dollar-for-dollar. Credits are reduced 33⅓¢ for each dollar of excluded cancelled debt.

7. **Foreign Tax Credit.** Reduce the credit carryover in the order they were taken into account. Reduction is 33⅓¢ for every dollar.

The taxpayer can elect to apply any portion of the tax attribute reduction required because of the exclusion of canceled debt to the bases of depreciable property held as of the beginning of the following year. The basis reduction is made in the following order:

1. Depreciable real property used in the taxpayer's trade or business or held for investment that secured the canceled debt.

2. Depreciable personal property used in the taxpayer's trade or business or held for investment that secured the canceled debt.

3. Other depreciable property used in the taxpayer's trade or business or held for investment.

4. Real property held primarily for sale to customers if the taxpayer elects to treat it as depreciable property on Form 982.

NOTE: When making this election, basis of assets can be reduced to an amount lower than the aggregate of the taxpayer's liabilities immediately after the discharge, unlike the limitation discussed under A. above. However, the basis cannot be reduced below zero.

Recapture

If the taxpayer reduces the basis of an asset and later resells the property at a gain, part of the gain due to the basis reduction is taxable as ordinary income under the depreciation recapture provisions. For real property the recapture is based on unrecaptured Section 1250 income subject to the maximum 25% federal income tax rate.

WHERE TO GO FOR MORE INFORMATION

- IRS Publication 908, Bankruptcy Tax Guide
- IRS Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (For Individuals)
- Real Estate Property Foreclosure and Cancellation of Debt ATG, available at **www.irs.gov/pub/irs-utl/real_estate_foreclosure_atg.pdf**
- The instructions to Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

CHAPTER 3: CAPITAL GAINS AND LOSSES

Learning Objectives

Completion of this chapter will enable participants to—

- Calculate gains, losses, and basis.
- Determine whether a sale is capital or ordinary in nature.
- Identify methods to report sales on IRS prescribed forms.
- Differentiate between various types of deferred compensation plans and stock options.
- Determine when a bad debt qualifies as a business or non-business bad debt.

WHAT'S NEW

1. The IRS continues to pursue syndicated conservation easements as abusive.
2. The IRS, taxpayers, and the courts collide on short sales when property is sold to pay off third-party debt.

CAPITAL GAINS

The TCJA retained the current maximum rate on capital gains and retained the existing break points as 2017. They were indexed for inflation. (See the Gear Up Cheat Sheets at the beginning of this manual for rate details.)

The 0% tax rate applies to most long-term capital gain, qualifying dividend income, and Qualified Small Business Stock (QSBS) that would otherwise be taxed at regular capital gain rates. The 0% tax rate does not apply to unrecaptured Section 1250 gain, which is taxed at a maximum rate of 25%, or collectibles gain, which is taxed at a maximum rate of 28%.

The Net Investment Income Tax (NIIT) continues to be a component of capital gains taxation. (See Chapter 18 for NIIT details.) The result of the long-term capital gains (LTCG) tax rate of 20% plus the NIIT of 3.8% means that a LTCG could be taxed at as much as 23.8%.

TCJA excluded patent, invention, model, or design (regardless of whether patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property from the definition of a capital asset. This applies to dispositions after December 31, 2017. Even though patents are excluded from the definition of a *capital asset* under IRC Sec. 1221(a)(2), certain transfers of patents by inventors and certain financial backers are treated as sales or exchanges of capital assets under IRC Sec. 1235.

Partnerships may issue profits interests (often called “carried interests”) to key service providers. The holders of the interest prior to the TCJA got long-term capital gain treatment if held in the partnership a year and a day. Under the TCJA, certain gains from partnership profits interests held in connection with performance of investment services are short-term capital gains if held for three years or less.

CAPITAL LOSSES

Capital losses are netted against capital gains. The netting process is done first by each tax rate group where gains and losses are netted to create a net gain or loss. Then short-term capital gains and losses are netted against each other. Finally, long-term capital gains and losses are netted against each other (IRS Notice 97-59).

A net short-term or long-term capital loss is netted against the net long-term capital gain rate from the highest capital gain bracket (28%) to the lowest.

Net capital losses are deducted against ordinary income up to $3,000 per year (the same $3,000 since 1978) (IRC Sec. 1211).

OBSERVATION: Any unused capital loss carryovers will evaporate upon the death of the taxpayer is those capital loss carryovers that are not consumed on the taxpayer's final return will be lost forever. In the case of a married filing joint return an allocation of capital loss worksheet should be maintain reflecting how much of the loss belongs to each spouse.

Excess capital losses are carried over until exhausted. They retain their initial short-term or long-term character in the year to which they are carried.

There is a limited offset by capital losses to gross investment income in the NIIT calculation. (See Chapter 18 for NIIT details.)

PLANNING TIP—Harvesting Losses: Your inexperienced taxpayer will react negatively when the concept of selling an investment at a loss is discussed. The harvesting of losses is a savvy tax move that should be discussed with all clients but particularly with those of advancing age as based on current law the loss evaporates when the taxpayer dies as discussed earlier.

Another planning opportunity of tax loss harvesting is the ability to use those losses against future gains. This can yield tremendous tax savings by reducing the tax due on those items sold at a gain because it was the right thing to do for the portfolio.

CAPITAL GAIN AND LOSS PLANNING TIPS

1. *Take advantage of the 0% rate.* Lower-income taxpayers are in a position to sell capital assets and pay no tax. Higher-income taxpayers may want to give appreciated stock to their lower-income children or parents, who can then sell it and pay no tax. Practitioners should watch out for the annual gifting limits and "kiddie tax" on this strategy.

OBSERVATION: Any taxpayer who owns capital assets should be monitoring their taxable income to take advantage of the 0% LTCG tax rate. These taxpayers will frequently have income that fluctuates from year to year. While the threshold is relatively small ($40,400–$80,800), a 0% LTCG tax rate can save a taxpayer normally in a 15% tax bracket up to $6,000 to $12,000 annually.

2. *Donate appreciated stocks.* Charitable minded taxpayers can donate appreciated stocks to qualifying charities and avoid capital gain by deducting the fair value of the gift. The qualifying charity does not pay tax since they are a non-profit organization not subject to tax.

3. *Remove stocks with capital losses.* Use a trading system that removes stocks with capital losses and replaces them with similar but not identical securities.

4. *Use capital losses to offset ordinary income.* Sell enough stock to create at least $3,000 of capital losses to offset ordinary income where appropriate.

OBSERVATION: If the lower threshold for estate tax and/or carryover basis rules as proposed are adopted, this technique can be more valuable by obtaining a current tax deduction and reducing the size of the taxable estate.

5. *Consider investment income election of LTCG and qualifying dividends.* When a taxpayer has investment interest expense and does not expect to generate enough investment income in the foreseeable future to use the deduction, the practitioner should consider the election to treat long-term capital gains and qualifying dividend income as investment income. The investment income can be used to deduct investment interest expense. Taxpayers in the 15%-or-lower tax brackets should not make the election since they would see no tax benefit.

PLANNING TIP: The election to treat long-term capital gains and qualifying dividend income as investment income is made on line 4g of Form 4952. The amount comes first from net capital gain and then from qualifying dividends unless a different method is chosen. The election can only be revoked with IRS consent [Reg. §1.163(d)-1]. The election is made on a year-by-year basis.

6. *Consider investing in Qualified Opportunity Zone funds* (see Chapter 21).

COST BASIS REPORTING

Cost basis is the original cost of an asset adjusted for various items, such as stock splits, liquidating dividends, and capital distributions. It is used to calculate capital gain or loss on an investment.

In an attempt to reduce under reporter inquiries, broker/defined reporting agents have been required to file Form 1099-B with additional reporting details for the sale of "covered" securities since 2012:

1. Date of Acquisition (Box b) and Date Sold (Box c)

2. Gross proceeds, (Box d)

3. Adjusted basis in any "covered" securities, and (Box e)

4. Whether any gain or loss with respect to the security is short-term or long-term under IRC Sec. 1222 [IRC Sec. 6045(g)].

5. Amount of accrued market discount.

6. Wash sale amounts.

Basis will be determined in the following manner:

1. Stock that has been sold will apply cost basis based on first-in, first-out (FIFO) method or the specific identification method where the customer adequately identifies the security to the broker prior to the sale and makes an election.

2. Mutual fund basis is calculated using the above cost basis or average basis if elected. Average basis is the total cost of shares owned divided by the total number of shares owned. The average basis is computed using all shares in the fund regardless of holding period. The holding period is determined on a FIFO basis.

3. Regulated investment companies (RICs) and dividend reinvestment plans (DRPs) are treated the same as mutual funds. The broker's default method is used unless the customer notifies the broker and elects another method prior to sale.

Short Sales

The IRS Foreclosure Guide defines a *short sale* as a sale of mortgaged real estate property in which the proceeds from selling the property will fall short of the total balance owed by the borrower. Short sale agreements do not necessarily release the borrower from their obligation to repay any loan deficiency unless specifically agreed to between the lender and property owner under governing state law.

Short sale proceeds will be reported in the year in which the sale is closed [IRC Sec. 6045(g)(5)]. Publication 544 (as the IRS is now relying on *Briarpark Ltd v. Comm.*, T.C. Memo. 1997-298), indicates that the sale of a property subject to a nonrecourse debt sales price is the amount of the debt *and not* the sale price received from the buyer. The outcome of this treatment would be as follows:

1. Nonrecourse Debt: $1,200,000

2. Sale Price: $1,000,000

3. Basis of Property: $1,050,000

4. Gross Sale per Publication 544 and *Briarpark*: $1,200,000

    a. Net Gain/Loss to be Reported: $150,000

    b. COD: $0

5. Gross sale per Short Sale Rules under Reg. §1.1001-2(a)(1): $1,000,000

    a. Net Gain/Loss: ($50,000)

    b. COD: $200,000

Most of the time, reporting received will be a Form 1099-S reflecting a gross sales price of $1,000,000 and a Form 1099-C reporting COD of $200,000; however, several lenders in nonrecourse states like California are indicating they will be reporting as indicated by *Briarpark* and Publication 544 per recent IRS guidance. The warning is as follows: carefully examine and determine exactly what the numbers on the Form 1099-S and/or 1099-C actually represent (see Chapter 2) by carefully reviewing any associated sales accounting documents.

Wash Sale

The only time the loss postponed will be included in basis is if the wash sale takes place in the same account or unless the IRS provides otherwise. Misreporting of wash sales occurs frequently and the best practice would be to maintain a workpaper on wash sale adjustments in past years.

ABANDONED PROPERTY RULES

The problem of unclaimed property held by Secretaries of State (in most instances), continues to grow. While billions of dollars are claimed by their rightful owners each year, much of this property continues to languish in the hands of differing federal and state governmental entities. The process is called *escheatment*, and requires the holder (fiduciary) of the property to turn the property over to their respective state or federal authority.

There are several key items to understand regarding unclaimed property:

- *Unclaimed property* are assets where the rightful owner cannot be located.
- Escheatment is invoked when a period of dormancy has occurred. This period for most jurisdictions is five years since the last recorded access of the property by the owner.
- There is a claim process in all jurisdictions to reassert the taxpayer's claim of the property. While all states have some kind of streamlined consolidated process, the federal claims processes are disjointed.
- The property is most frequently converted to cash and turned over to the respective authority.
    - Stock converted to cash will be a taxable transaction, and Form 1099-B will be issued.
    - Retirement accounts will be liquidated and subject to Form 1099-R reporting. The IRS has instituted a requirement of mandatory withholding (see Chapter 16), but there is an extended rollover opportunity.

OBSERVATION: When a taxpayer is no longer receiving a Form 1099-DIV, or they have received a 1099-R but are not certain as to why they received the statement, it is a good time to check on the unclaimed property resources of their state. These can be located at **https://unclaimed.org/search/database**.

BASIS OF STOCK RECEIVED IN AN INSURANCE COMPANY DEMUTUALIZATION

After a period of litigation and some continued discussions, tax treatment of stock received in a demutualization of an insurance company has been determined likely to be ZERO. It should be noted there is one dissenting case leaving a difference of opinion between U.S. Circuit Courts.

In *Fisher v. United States* (102 AFTR 2d 2008-5608), a split decision by the circuit courts has led to uncertainty. The *Dorrance* case found no costs of ownership, but the *Fisher* case did. The Court of Claims used the open transaction doctrine to determine that the basis was the FMV at the time the stock was received in the demutualization.

A series of court cases involving the Dorrances ended in a victory for the IRS, with the result that there is no basis in shares received as a result of demutualization:

1. The initial determination in a district court case (DC AZ 07/09/2012) was that there was to be an allocation of premiums paid between return of capital and insurance cost (i.e., basis in the stock received).

2. In a second district court case (DC AZ 03/19/2013) a second determination was made that all premium payments were to be allocated to return of capital (i.e., basis in the stock received).

3. However, the final court determination (CA 9 12/09/2015) and the current opinion of the IRS is that stock received in an insurance company demutualization has zero basis.

Numerous practitioners continue to file returns supporting the idea of stock basis using the *Fisher* case as substantial authority. An expanded discussion can be found at **www.currentfederaltaxdevelopments.com/blog/2015/12/11/stock-received-in-demutualization-has-zero-basis-per-ninth-circuit-creating-split-with-federal-circuit**.

OBSERVATION: There are many owners of demutualized stock that have no idea they actually own stock in their insurance company. Much of this stock ends up in the abandoned property coffers of the Secretary of State (see immediately preceding discussion). Upon sale there is genuine surprise that the surrender of the stock is a sale that the IRS maintains is 100% taxable.

BASIS OF GIFTED PROPERTY

There are special rules under IRC Sec. 1015 governing basis when property is received as a gift. To calculate basis, the taxpayer must first determine the donor's adjusted basis, the FMV at the time of the gift, and the amount of gift tax paid, if any.

If FMV at the date of the gift is more than the donor's adjusted basis, the recipient's basis is the donor's basis. If gift taxes are paid, then the recipient's basis is increased by the part of the gift tax paid that resulted from the net increase in the value of the gift.

EXAMPLE: Determining basis of gifted property

Kelley gifted an asset with an adjusted basis of $5,000 and a FMV at the time of the gift of $21,000. Kelley is over her lifetime gifting exclusion and has to pay an assumed gift tax of $2,800. The gift tax adjustment is $2,133 [$2,800 × ($16,000 ÷ $21,000)]. Therefore, if the gift recipient later sells the gifted property for $10,000, the recipient will realize gain of $2,867 [$10,000 – $7,133 basis ($5,000 donor basis plus the $2,133 gift tax allocation)].

If the FMV at the date of the gift is less than the donor's adjusted basis, the basis for gain is the same as the donor's adjusted basis. The basis for loss or other disposition is the FMV at the time of the gift. If the donor's adjusted basis computation results in a loss, and the FMV computation results in a gain, no gain or loss is recognized by the taxpayer.

PLANNING TIP: Owners of assets with an FMV less than the cost basis should consider selling the assets and gifting the proceeds.

FORM 8949 AND SCHEDULE D

Taxpayers who sell stock or any other capital asset (not reported on another form), deduct non-business bad debts, and or have involuntary conversions (other than casualty losses) of personal capital assets, generally must file Form 8949.

Form 8949 lists each transaction by type and holding period, and then carries the totals to Schedule D.

PLANNING TIP: Form 8949 is not required when a Form 1099-B is received that shows basis was reported to the IRS and no code adjustments are required. The transactions can be reported directly on Schedule D, line 1a for short-term, and line 8a for long-term. For practice consistency, the author recommends that all transactions be entered on Form 8949 and carried to Schedule D.

A separate Form 8949 must be filed for each of three categories and separately for short-term (Part 1, page 1 Boxes A–C) and long-term (Part 2, page 2 Boxes D–F) gains and losses, which potentially amounts to three two-sided Forms 8949 on a single tax return:

1. Basis (when applicable) is shown on Form 1099-B (known as a “covered security”), first box (Box A or D),
2. Basis is not shown on Form 1099-B, second box (Box B or E), or
3. No 1099-B is received for a gain or loss last box (Box C or F).

Form 8949 is cumbersome. There are many variations of Form 1099-B, which creates uncertainty of the exact reporting required for Box A, B, C, D, E, or F.

According to official IRS terminology, basis that is reported on a Form 1099-B transaction is covered (reported to the IRS on Form 8949 in Box A for short-term and Box D for long-term) and basis that is not reported (or not required) is non-covered (reported in Box B for short-term and Box E for long-term). Taxpayers who have a gain or loss not reported on a 1099-B should report in Box C for short-term and Box F for long-term.

PLANNING TIP: A complete and careful review of Form 1099-B and the supplemental gain and loss reports is necessary to clarify which box to use!

WARNING: Regardless of what a broker reports on Form 1099-B, the taxpayer is still obligated to maintain and report accurate trade history records. The standard of reporting for the broker is information that is reasonably known to the agent.

Seventeen codes are available for reporting the character of transaction adjustments reported on Form 8949 to the IRS. These codes can be found in the Form 8949 instructions. Any of the 17 codes that apply should be indicated on Form 8949 in Column (f) (**www.irs.gov/pub/irs-pdf/i8949.pdf**, pages 8–10).

PLANNING TIP: More than one code may be used in Form 8949, column (g). If none of the codes are applicable, columns (f) and (g) may be left blank.

The IRS has provided methodology to consolidate the required reporting (see Form 8949 instructions for details):

1. Use substitute 1099-B statement totals—

    a. Enter the name of the broker followed by “see attached statement” in column (a).

    b. Leave column (b) and (c) blank.

    c. Enter Code “M” and any other applicable codes in column (f). Code “M” is for multiple transactions on a single row.

    d. Enter the totals that apply in column (d), (e), (g), and (h).

A separate Form 8949 line should be used for each broker statement. The attached statement format must be “similar” to the Form 8949 format and the attached statement totals must agree with the Form 8949 totals.

You can still e-file the return by attaching Form 8453 (Tax Transmittal for an IRS e-file Return) and checking the last box, as well as attaching the broker’s statement (or other similar format) as a paper attachment. A practitioner’s tax software should allow a PDF version of the Schedule D activity to be transmitted electronically.

Most software providers provide a download utility to allow a transaction file to populate the Form 8949.

> **OBSERVATION:** Some tax software companies have added a feature where you can enter each an identified brokerage statement separately which produces a tracking worksheet.

For the date acquired in column (b), the actual date should be used, with the following exceptions:

1. Entering “various” if a block of stock that was purchased in more than one transaction is sold or purchased. However, the long-term and short-term totals must still be separated.

2. Entering “inherited” if property acquired through inheritance is sold. Inherited stock will produce a long-term result whenever it is sold.

WASH SALES (IRC SEC. 1091)

A loss from the sale or disposition of stock or securities is not currently deductible if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities [IRC Sec. 1091(a)]. These rules apply only to sales that result in a loss.

Stock or securities include stock options, but do not include commodity futures contracts and foreign currencies.

For the wash sale rules to apply, the stocks or securities must be substantially identical. All facts and circumstances must be considered in each case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation.

Dealers in stocks or securities are not subject to these rules if the loss is from a transaction made in the ordinary course of business [Reg. 1.1091-1(a)].

When a wash sale deferred loss transaction occurs, the basis of the substantially identical securities is increased by the realized but unrecognized loss. The holding period of the acquired securities includes that of the original stock sold.

Review Form 1099-B, Code W, wash sale reporting requirements reported in Form 8949's instructions.

DEFERRED COMPENSATION PLAN OVERVIEW

Deferred compensation is an arrangement in which a portion of an employee's income is paid out at a date after the income was actually earned. Examples of deferred compensation include salary retention agreements, retirement plans, and stock options.

Deferred compensation plans are classified as *qualified* or *nonqualified plans*:

1. *Qualified plans* include statutory stock option plans (included in this chapter), along with traditional retirement plans (covered in Chapter 16). Qualified plans receive special tax benefits but are also subject to greater compliance requirements.

2. *Nonqualified plans* do not receive special tax treatment but offer greater flexibility in tailoring compensation packages to selected employees and independent contractors. These plans can provide for:

   a. Funding for stock buyout plans

   b. Incentive compensation for employees

   c. A process to allow employees to purchase ownership interests in the company.

The IRS updated the Non-Qualified Deferred Compensation Audit Technique Guide in June 2015. This serves as a roadmap for what the IRS considers potential problems of IRC Sec. 409A plans.

Failure to comply can subject the taxpayer to a 20% penalty.

NONQUALIFIED COMPENSATION PLANS AND REPORTING

Income is generally taxable in the year that it is either credited, set apart, or otherwise made available without restrictions to the taxpayer (i.e., elimination of substantial risk of forfeiture).

To defer taxation, the employee must not have constructive receipt of the funds or receive an economic benefit. (If applicable, the plan must meet the requirements of IRC Sec. 409A, discussed later in this chapter.)

1. *Constructive receipt* occurs when there are no substantial restrictions or limitations on the employee's right to receive the deferred pay.

2. *Economic benefit* occurs when the employee acquires a non-forfeitable right to the assets of the employer that supersedes the right(s) of the employer's general creditors (Rev. Rul. 68-99). This is a concern for funded plans.

EXAMPLE: Treatment of a deferred compensation agreement

Marty entered into a deferred compensation agreement in which his employer, P-Wall, Inc., agreed to pay $30,000 upon his retirement. Assuming the plan meets the requirements of IRC Sec. 409A, constructive receipt for this unsecured promise to pay does not occur until the deferred compensation is due and payable upon Marty's retirement.

PLANNING TIP: There are typically options for taking the money in the deferral period. It can be lump sum or spread over years. Taxpayers often mistakenly take the money lump sum at the end of the deferral period. The advisor needs to consider bunching deductions (like charitable contributions) in that year.

CAUTION: There are possible state savings by spreading the deferred income into later years if the taxpayer is considering moving to an income tax-free state (like Florida). However, some states still try to claim this as income earned before the taxpayer moved.

The employer deducts the deferred compensation in the tax year that includes the employee's year end in which the income was recognized:

1. If the compensation payment is made within 2½ months of the employer's year end in which it was earned, the payment is not treated as deferred compensation and is deductible by the employer.

2. The 2½-month rule does not apply to payments made to an individual directly or indirectly owning more than 50% of the company's stock.

Deferred compensation is subject to federal income tax withholding and employment taxes when actually or constructively received. Amounts included in income are reported in Box 11, Nonqualified Plans, and included in Box 1, Wages, Tips, and Other Compensation, of Form W-2.

For nonemployees, the income is reported in Box 1 of Form 1099-NEC.

Deferrals under a Section 409A nonqualified plan are to be reported in Box 12 of Form W-2, using code Y. However, per Notice 2008-115 (modified by Notice 2010-6), the IRS has suspended this requirement until further notification.

Amounts included in income for failure to meet Section 409A requirements are included in wages in Box 1, and reported in Box 12 of Form W-2, using code Z. These amounts are subject to the additional 20% penalty and increased underpayment rate.

Amounts paid to a nonemployee spouse who receives benefits incident to a divorce are reported on 1099-MISC in Box 3, Other Income. The employer is to use the supplemental wage flat rate for the withholding.

No federal income tax withholding is required on amounts paid to beneficiaries of deceased employees. Amounts paid are reported on Form 1099-R.

Careful review of plans subject to IRC Sec. 409A is critical; any agreement that defers payment to a later year may be such a plan. If the agreement contemplates payment at a future date it should be reviewed by a Section 409A professional.

In Chief Counsel Advice 201518013, an executive and the company he worked for attempted to correct an error in a compensation retention agreement. It was determined that the agreement did not fully comply with

IRC Sec. 409A, at which time the agreement was modified. The "repair" of the agreement failed to meet Section 409A rules, as the correction of the plan did not occur more than 12 months before the first payment contemplated under the plan. This failure demonstrates how incredibly convoluted this section of the Code can be and the need for vigilance.

STOCK OPTIONS

Stock options are divided into two categories:

1. *Non-statutory* Stock Options (Non-qualifying Stock Options or NQSOs)

2. *Statutory* Stock Options, which are further divided into—

    a. Employee Stock Purchase Plans (ESPPs) IRC Sec. 423

    b. Incentive Stock Options (ISOs) IRC Sec. 422

EXAMPLE: Stock options life cycle and effects

	Grant Date	**Vesting Date**	**Exercise Date**	**Expiration Date**
What happens?	Company gives employee an opportunity to buy stock.	"Waiting period" ends and employee may exercise option (or not).	Option holder (employee) buys the stock at the option price.	Option holder forfeits right to buy stock under grant.
What is cost?	Nothing.	Nothing.	Option price times number of shares.	Nothing—lost opportunity.

Note: These dates are in the order in which they occur. Option holders generally do not have a reportable event until the options are exercised.

A Section 83(b) election gives an employee the option to pay ordinary income tax on the total fair market value of restricted stock at the time of grant:

1. Additional growth will then be taxed as a capital gain.

2. This can be a great strategy for stock that is expected to increase in value over time especially start-up entities that have minimal fair value early on.

Generally effective with respect to stock attributable to restricted stock units (RSUs) exercised or settled after 2017, a qualified employee can elect to defer (for income tax purposes) recognition of the amount of income attributable to qualified stock transferred to the employee by the employer [IRC Sec. 83(i)]:

1. The election applies only for income tax purposes; the application of FICA is not affected.
2. This election will allow the employee to convert the gain on the RSUs to long term capital gain.

(For additional details on Section 83(b) and 83(i) elections, refer to Chapter 11 of Gear Up's *Business Entities* manual.)

NON-STATUTORY STOCK OPTIONS

A *Non-statutory* or *Nonqualified Stock Option* (NQSO) is one that does not meet the specific requirements outlined in IRC Sec. 421 for special tax treatment and may be granted to employees or independent contractors.

The most common tax result is compensation income on the difference between the exercise price and the FMV at the time of exercise.

EXAMPLE: Treatment of non-statutory stock options

Victoria is an employee of The Secret, Inc. (TSI). The company grants her non-statutory stock options to purchase 1,000 shares at $9.00 per share. Victoria exercises the options at a time the stock is trading at $20. She will have additional compensation of $11,000 [($20.00 FMV – purchase price of $9.00 per share) × 1,000 shares]. TSI reports this income on Victoria's Form W-2, in Box 12, noting code V.

Warning: Brokers are required to report basis on Form 1099-B as what was paid for the stock at exercise or purchase (no step up for the amounts reported as income on the Form W-2). Without careful review, a large gain could be accidentally reported. Code B, column (f) will indicate why there is an adjustment to the reported gain. Column (g) should be used to show a decrease to the gain for amounts reported on the Form W-2, which are typically labeled Code V.

Details: In the previous example, assuming no brokerage charge, Victoria would show a $9,000 basis (the amount from her Form 1099-B) on Form 8949 Column (e). She would then show Code B in Column (f) and an $11,000 negative adjustment in Column (g). She would not report any gain or loss in Column (h), as follows:

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	**Adjustment, if any, to gain or loss.** If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
NSO The Secret Inc	07/01/2021	07/01/2021	20000	9000	B	-11000	

EMPLOYEE STOCK PURCHASE PLAN (ESPP)

Employee stock purchase plans (ESPPs) allow employees to set aside a portion of their income to purchase employer stock. Typically, the purchase plan price is set at 85% of the value of the stock at the grant or exercise date.

In a non-qualified disposition, the bargain element (typically 15%) is treated as compensation and increases the basis. Any non-qualifying disposition will be subject to the bargain element and treated as compensation subject to reporting by employer and applicable payroll taxes.

A *non-qualifying disposition* is one that occurs within two years of the date of grant and within one year of the exercise date. The *initial bargain* is compensation reported on Form W-2. Any gain or loss in excess of adjusted basis is either short-term or long-term capital gain or loss, depending on the holding period.

> **OBSERVATION:** The taxable bargain element is difficult to identify. There is no reporting on Form W-2 to identify the compensatory element. In most situations the bargain element compensation can only be found on the payroll stub.

A *qualifying disposition* will result in ordinary income up to the FMV at date of exercise and is reported as such on the individual tax return. Any excess gain (selling price less adjusted basis) is long-term capital gain.

> **NOTE:** Form 3922 is sent to the taxpayer to assist in determining basis on the sale of ESPP stock, but frequently is not that helpful.

INCENTIVE STOCK OPTION (ISO)

Stock acquired under an Incentive Stock Option (ISO) plan that meets the "qualifying disposition" requirement will receive a beneficial tax treatment. The entire gain from the sale of stock may be treated as capital gain, even if the stock was acquired at a cost of less than fair market value (FMV).

Qualifying Disposition is defined as follows:

1. The stock is not disposed of within two years after grant or within one year after exercise.

2. At all times during the period beginning with the grant date and ending on the date three months prior to exercise, the optionee is an employee of the corporation granting the option. The three-month period is extended to one year for an employee who is disabled [IRC Sec. 422(c)(6)].

Taxation of Qualifying Dispositions

Regular Tax

The recipient recognizes no regular income upon the grant or the exercise of the option. The exercise price becomes the basis in the stock.

AMT

At the time of exercise, bargain element is added to alternative minimum taxable income. The bargain element is the difference between the exercise price and the FMV at the time of exercise. The basis for AMT purposes is exercise price plus the bargain element even if no AMT results. Accordingly, upon sale, a negative AMT adjustment must be made for the basis differential.

Form 3921

This form assists taxpayers in determining basis on the exercise or sale of ISOs.

Taxation of Disqualifying Dispositions

Regular Tax

The taxpayer has ordinary income for the lesser of the gain on the sale of the stock or the bargain element at the time of exercise. A loss on the sale limits the ordinary income recognized provided the loss, if sustained, would be recognized [Reg. 1.422-1(b)(2)(ii)], thus the reduction is not available for stock sales to related parties (IRC Sec. 267). Basis for regular tax purposes is determined by reference to both the strike price and the income recognized. The 1099-B will not reflect the ordinary income in the cost basis for a covered security.

AMT

No AMT adjustment is required if the exercise and the sale of the stock is in the same tax year. If the taxpayer exercises the option in one tax year and sells the stock in the following tax year, the AMT adjustment for the bargain element must be made in the year of exercise. Thus, the taxpayer could incur both AMT on the exercise and ordinary income on the sale.

PLANNING TIP: The true power of a stock option is that the holder gets the benefit of stock ownership without financial investment. Taxpayers should consider simultaneously exercising the option and selling the stock; a transaction often called a “cashless exercise.”

TCJA IMPACT: Prior to TCJA the AMT threshold was very low. As the current threshold for a married taxpayer exceeds $1 million, fewer taxpayers are subject to AMT. The tax trap of exercising ISOs without the resulting sale has been mitigated by that greater threshold. Consideration of the buy and hold strategy is more viable than it was prior to TCJA.

TREATMENT OF PUTS AND CALLS

The following is a summary of the tax treatment to the writer (seller or grantor) and holder (buyer or owner) on an option transaction:

Transaction	Writer, Seller, Grantor (Long)	Holder, Buyer, Owner (Short)
Option Is Written	Receives the premium—not a taxable event.	Pays a premium—not a taxable event.

Transaction	Writer, Seller, Grantor (Long)	Holder, Buyer, Owner (Short)
Put	Required to buy the security within a specified period of time at strike price. (Bullish and expects the security to increase in value.)	Has the right to sell the security within a specified period of time at strike price. (Bearish and expects the security to decrease in value.)
Put Is Exercised	Purchases stock at strike price. Option premium decreases basis in stock. Holding period begins on the day following the date of exercise.	Sells stock at the strike price. Gain or loss is recognized. Option price decreases amount realized. Long-term and short-term are determined by the holding period of stock.
Call	Required to sell stock within a specified period of time at the strike price. (Bearish and expects value of security to decrease.)	Has the right to purchase security within a specified period of time at the strike price. (Bullish and expects value of security to increase.)
Call Is Exercised	Owner sells the stock. Gain or loss is recognized. Premium received increases amount realized. Holding period is based on time the option is held.	Purchases stock at strike price. Option premium increases basis in stock. Holding period begins the day after the option is exercised.
Holder Sells the Option	It is not a taxable event since the obligation still exists.	Recognizes gain or loss equal to the difference between the premium paid and the proceeds from sale. Holding period is based on time the option is held.
Holder Lets the Option Expire	The premium payment for the put or call is treated as a short-term capital gain regardless of holding period.	A loss is recognized for the full option price since the investment is lost. Holding period is based on time the option is held.
Offsetting Option Purchased (Straddle)	If an identical option is purchased, a short-term gain or loss is recognized. It is the difference between the premium received and the purchase price of the offsetting option.	It is not a taxable event since the option is still open.

Options usually are thought of as stock market tools but are also widely used in real estate investing. Options are popular because the writer receives cash but does not have a tax consequence until the option lapse is exercised.

An agreement is a true option if it unconditionally binds the option writer to sell at the option's terms, while giving the buyer the right to accept or decline the terms. The theory of “open transaction” protects the option writer from tax consequences until the transaction is either consummated or the option lapses.

CAUTION: From the option writer's standpoint, a key tax trap to avoid when structuring an option is including provisions that resemble a lease or a sale agreement rather than an option (Elrod v. Comm., 87 TC 1046).

SECTION 1237 RELIEF

IRC Sec. 1237 allows taxpayers (other than C corporations) who are not real estate dealers to receive capital gain treatment when they subdivide a parcel of land to sell. Otherwise, the taxpayer is considered a real estate dealer (a person who holds lots for sale in the ordinary course of business) and the lots are treated as inventory subject to ordinary income tax on the gain when sold.

The seller must have held the property for at least five years unless inherited [Reg. 1.1237-1(b)].

The lot cannot have substantial improvements made to it. This is based on the facts and circumstances but is considered substantial if the improvement increases the land value by more than 10%. [Reg. 1.1237-1(c)]

After more than five lots are sold from the same tract, the sixth and later lots can be subject to ordinary income. This gain is limited to 5% of the selling price of each lot [IRS Sec. 1237(a)(5)].

PLANNING TIP: The seller cannot be considered a dealer merely because of advertising, promotion, selling activities, or the use of sales agents [Reg. 1.1237-1 (2)]. An election is required under IRC Sec. 1237(b)(3)(C).

QUALIFIED SMALL BUSINESS STOCK (QSBS) (SECTION 1202 STOCK)

C corporation stock (with assets not exceeding $50 million at the time of stock issuance) that is sold and was held for more than five years by the original owner of a qualified small business stock, qualifies under IRC Sec. 1202 for special tax treatment.

The PATH Act of 2015 made permanent the 100% gain exclusion (i.e., created a 0% tax rate) with no AMT preference from the sale of qualified stock acquired after September 27, 2010, and held for more than five years.

Acquisition Date	**Exclusion Amount**
Before February 18, 2009	50% with 60% exclusion for certain qualified business entities. An AMT preference item for 7% of the amount excluded.
After February 17, 2009 and before September 18, 2010	75% exclusion. An AMT preference item for 7% of the amount excluded.
After September 17, 2010	100% No AMT preference item

A qualified small business stock specifically excludes professional services or any business where the principal asset is the reputation or skill of one or more of its employees. It also excludes banking, insurance, financing, leasing, investing, farming activities, businesses involving product production or extraction eligible for depletion, hotels, and restaurants and similar type businesses.

The IRS has attempted to broadly define the exceptions to eligible businesses, but most court rulings have been taxpayer friendly.

- The sale of legal service policies and estate planning services through independent contractors, while reliant on the skill of the owners, was in fact the service plans being sold, not services. (*Owen, John P. v. Comm.*, TC Memo 2012-21)

- A company that worked with clients in the pharmaceutical industry helping to commercialize experimental drugs was in fact a qualified trade or business. (IRS Letter Ruling 201436001)

- A company that had a patent on a medical test and was in the business of analyzing the results of the test and preparing laboratory reports for health providers was a qualified trade or business. (IRS Letter Ruling 201717010)

The exclusion is computed at the shareholder level (eligible shareholders are individuals and pass-through entities) and is limited to the greater of $10 million or 10 times the aggregate adjusted basis of the QSBS originally issued by the corporation and disposed of by the taxpayer.

- If the stock was acquired by contribution of property, the basis is treated as equal to the FMV of the property at the time of transfer. [IRC Sec. 1202(i)(1)(A)]

- If the stock is held by a pass-through entity, the stock must qualify in the hands of the entity.

- If acquired via gift or inheritance the QSBS is considered acquired on the same dates and in the same manner as that of the transferor. [IRC Sec. 1202(h)(1)(A)]

ROLLOVERS UNDER IRC SEC. 1045

IRC Sec. 1045 permits holders of qualified small business stock to roll over their gains resulting from sale if they meet certain criteria:

1. The replacement stock must be held more than six months.

2. Gain is recognized only to the extent that the amount realized exceeds the cost of the qualified small business stock bought by the taxpayer during the 60-day period beginning on the sale date reduced by any portion of such cost previously taken into account.

Holding period of replacement stock includes the holding period of the stock sold.

DONATION OF CLOSELY HELD STOCK

When the shareholder of a closely held corporation has donative intent, a properly crafted contribution-redemption can be a great tax saver versus taking a cash dividend or other payment to cover the charity gift. There is a two-step test:

1. An actual transfer of the stock from the corporation to the charity. In some cases this can be effective for an S corporation as a C corporation if capital is trapped inside the S corporation and the basis is below FMV.

2. Without prearrangement, the charity sells the shares to her company.

EXAMPLE: Donation of closely held stock

Laurie owns 100% of Big Corp Inc (BCI), which she paid $10 per share for originally. The stock is now worth $1,000 per share. Laurie transfers 20 shares to Worthy Cause (WC) charity. Laurie actually wishes to support WC significantly in the future. WC (without prearrangement) sells their stock to BCI. This triggers a charitable tax deduction in the amount of $20,000 for Laurie. WC sells the stock to BCI, which will be recorded as treasury stock. Funds are moved to Laurie's benefit with no tax cost (as she gets a tax deduction). Upon the redemption of the stock, Laurie once again owns 100% of BCI.

SYNDICATED CONSERVATION EASEMENTS

The IRS has been pursing what it considers abusive tax shelters regarding syndicated conservation easements. These types of transactions are subject to the penalties and taxes associated with *listed transactions* under IRC Sec(s). 6611 and 6112.

The IRS has been attempting to identify and prosecute tax professionals who are involved with what the Service views as abusive shelters. On June 9, 2021, Georgia CPA Herbert E Lewis was indicted on tax conspiracy, wire fraud, and false tax return charges for work he performed on syndicated conservation easements. It should be noted that the IRS stated this is only the beginning. There is still a considerable amount of disagreement regarding the use of syndicated conservation easement partnerships between the IRS and taxpayers. Based on the IRS's current strategy, care should be exercised by the practitioner if a client is engaging in this type of investment.

With Announcement 2020-130, the IRS indicated they have developed a standardized settlement process. Letters have been sent to all taxpayers who are currently docketed with the U.S. Tax Court. The following are key issues of the settlement:

1. The deduction for the contributed easement is disallowed in full.

2. All partners must agree to settle, and the partnership must pay the full amount of tax, penalties, and interest before settlement.

3. "Investor" partners can deduct their cost of acquiring their partnership interests and pay a reduced penalty of 10%–20% depending on the ratio of the deduction claimed to partnership investment.

4. Partners who provided services in connection with any Syndicated Conservation Easement transaction must pay the maximum penalty asserted by the IRS (typically 40%) with no deduction for costs.

While much of the news regarding syndicated conservation easements has been the unyielding belief by the IRS that these types of transactions are fraudulent, there have been victories by the taxpayer. In *Pine Mountain Preserve, LLP*, (151 T.C. 247), a conservation easement valuation by the taxpayer was upheld. The lesson learned here is that not all syndicated conservation easements are unlawful and fraudulent, but the IRS continues to believe that they are.

BAD DEBTS

Individuals are allowed to deduct both business and non-business bad debts (IRC Sec. 166). However, there are key differences in the deductibility of the bad debts. To deduct a bad debt, the taxpayer must be able to prove that the debt is fully or partially worthless in the case of business bad debt [IRC Sec. 166(a)], or fully worthless in the case of *non*-business bad debts [IRC Sec 166(d)].

Worthlessness of a debt is a question of fact, and all pertinent evidence should be considered, including the value of collateral and the financial condition of the debtor. Absent proof, the taxpayer's best documentation is a detailed record of the collection efforts.

BUSINESS BAD DEBTS [IRC SEC.166(D)(2)]

To be considered a business bad debt, the debt must either have been created or acquired in the taxpayer's trade or business or was closely related to the trade or business when it became worthless. Some examples include loans to clients and suppliers, debts of insolvent partner, loan guarantees in the course of business, or being in the business of making or guaranteeing loans.

To be a business bad debt, the dominant motivation for making the loan must be business oriented. A significant motivation does not satisfy this requirement [United States v. Generes, 405 U.S. 93 (1972)].

Business-related bad debts (debts arising from a trade or business) are fully deductible in the year they become partially or totally worthless [IRC Sec. 166(d)(1)(B)].

Business bad debt is reported based on the business structure:

1. A sole proprietor reports the business bad debt that arises in the ordinary course of an individual's unincorporated business as an ordinary deduction on Schedule C or Schedule F (IRS Pub. 535, Business Expenses).

2. A corporate employee-shareholder formerly reported business bad debt as an itemized deduction on Form 1040, Schedule A, subject to a 2% AGI limit. This deduction is suspended under the TCJA for tax years beginning after December 31, 2017 and before January 1, 2026.

COURT CASE: In *Sensenig*, the taxpayer owned an S corporation that provided tax preparation services. The S corporation advanced funds to various small businesses in which the taxpayer took a minority equity interest. The S corporation reported a $10.7 million bad debt. The Tax Court concluded that the advances were capital contributions, not loans. There were no formal loan agreements, nor interest charged. The S corporation also continued to finance the businesses in years after the deduction was claimed, which indicated the advances were not worthless. [*John & Alta Sensenig v. Comm.*, TC Memo 2017-1 and upheld by the 3rd Circuit Court of Appeals, 121 AFTR 2d 2018-505 (CA3)].

NON-BUSINESS BAD DEBTS

Bad debts, that are not business bad debts, are non-business bad debts. In order to deduct a bad debt, it must be a real, or genuine, debt. This means there must be a creditor-debtor relationship based on a valid and enforceable obligation to repay a determinable sum of money [Reg. 1.166-1(c)]. The loss is considered a short-term capital loss regardless of terms.

No deduction for partial worthlessness is allowed. The deduction can only be taken in the year in which it becomes totally worthless.

Non-business bad debt is reported as a short-term capital loss on Schedule D. A statement should be attached to the return for each debt documenting a description of the debt, including amount and due date, the name and relationship of the debtor, efforts made to collect the debt and why the debt is deemed to be worthless in the current year.

Loans between family members are subject to additional scrutiny and are generally considered “gifts” unless it can be established that a bona fide loan exists. Evidence of a bona fide loan include note or other evidence of indebtedness, interest being charged, fixed repayment schedule, security or collateral, demand for repayment, and payments being made. Loans to insolvent family members are considered gifts, since a reasonable expectation of repayment cannot exist.

Individuals often guarantee loans for friends or family members as a personal favor without receiving any consideration. Payments made under these guarantees are considered gifts and cannot lead to a bad debt deduction.

SECTION 1244 STOCK

Stock losses on the sale of small business stock are deducted as ordinary losses up to $50,000 ($100,000 MFJ filers). Losses are claimed on Form 4797 Part II. Any loss in excess of the limit is considered a capital loss.

Applies to shareholders who are individuals (and in certain situations, partnerships). (See Gear Up’s *Business Entities* manual for details.)

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 525, *Taxable and Nontaxable Income*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRS Pub. 550, *Investment Income and Expenses (Including Capital Gains and Losses)*
- IRS Pub. 551, *Basis of Assets*
- Form 1099-B Instructions
- Form 1040, Schedule D, Instructions (includes Form 8949 instructions)

CHAPTER 4: 1040 PENALTIES AND ABATEMENTS

Learning Objectives

Completion of this chapter will enable participants to—

- Recognize the penalties that can apply to a 1040 return.
- Determine how to apply for an abatement of a penalty.
- Recognize that the IRS frequently proposes penalties that are not appropriate.

WHAT'S NEW

1. Discussion of abatements of penalties.
2. Expanded discussion on reasonable cause penalty abatement defense.

SUMMARY OF STATUTORY AND REGULATORY EXCEPTIONS TO PENALTIES

Tax legislation may provide an exception to a penalty. Specific statutory exceptions can be found in either the penalty-related IRC section(s) or the accompanying regulation(s). The following Example is a synopsis of available relief provisions listed in section 20.1.1.1.2 of the Internal Revenue Manual.

EXAMPLE: Relief Provisions Available in the IRM		
Legal Reference	**Title**	**IRM Reference**
IRC Sec. 6654(e)(1), (2), or (3)	Estimated Tax Penalties (ES)	20.1.3
IRC Sec(s). 75002(a) and 7502(e) [**Note:** IRC Sec. 7502(e) does not apply to deposits due after 12/31/10.]	Timely Mailing Treated as Timely Filing and Paying	20.1.2 and 20.1.4
IRC Sec. 6724(c)	Waiver: Definitions and Special Rules, Information Return Penalties	20.1.7.12
IRC Sec. 6404(f)	Abatement of Any Penalty or Addition to Tax Attributable to Erroneous Written Advice by the Internal Revenue Service	20.1.1.3.3.4.1
IRC Sec. 7508	Time for Performing Certain Acts Postponed by Reason of Service in Combat Zone (This provision applies *only* to *Presidentially* declared combat zones.)	20.1.2.1.2.1, *Combat Zone—IRC 7508*
IRC Sec. 7508A and Treas. Reg. 301.7508A-1	Authority to Postpone Certain Deadlines by Reason of Federally Declared Disaster or Terroristic or Military Actions	25.16.1, *Disaster Assistance and Emergency Relief, Program Guidelines*, and 20.1.2.1.2.2, *Federal Disaster Area—IRC 7508A*

OBSERVATION: It should be noted that many penalty provisions are subject to regulatory provisions. Whenever the taxpayer faces a penalty issue, a review of the differing provisions can be a great tax saver.

Treat every contact with the IRS as if there will be a need to document any statement made by the IRS.

PRACTICE TIP: All contact with the IRS should be documented regarding the topic, time, and date of the discussion; the IRS employee's name and ID number; and any agreements made with or instructions received from the IRS. Consider faxing any additional information to the IRS employee along with a summary of the discussion.

As a result of the COVID-19 pandemic, there have been numerous compliance extensions regarding filing and/or payment:

1. The IRS—as a result of office closures and work stoppages, plus regulatory and statutory postponement of both filing and/or payment—is likely to create confusion for taxpayers and preparers in the foreseeable future.

2. It is the author's expectation that we are going to see notices which attempt to collect on penalties that are not valid.

3. Reviewing notices to determine their validity is always a best practice but will be even more critical due to the increasing number of statutory/regulatory payment exceptions due to the pandemic.

There are two important resources available at **www.irs.gov** which practitioners should review when working with a penalty:

1. Penalties(**www.irs.gov/payments/penalties**),

2. Internal Revenue Manual Penalty Handbook (**www.irs.gov/irm/part20**).

When working with the Internal Revenue Service there are five essential reasons that a penalty is abated:

Abatement Reason	Explanation	Examples
1. IRS Error	Oral or written advice by IRS	The IRS provides a determination of a tax position that was in error.
2. Statutory Exception	A specific exclusion from a penalty provided by law	• Disaster Area Relief • Combat Zone Relief
3. Appeals – Hazards of Litigation	IRS Settlement – Based on the likelihood of winning in Court	Taxpayer and the IRS settle a dispute in Appeals that removes the penalty.

Abatement Reason	Explanation	Examples
4. Administrative Waiver	The penalty is removed to facilitate tax administration	• Hardship failure to pay penalty relief • First Time Abatement
5. Reasonable Cause	• For late filing and late payment penalties: The taxpayer has circumstances outside of their control that made them unable to comply. • For return accuracy penalties: A reasonable attempt was made to report the proper amount of tax on a tax return.	There is no shortage of Reasonable Cause arguments: • Long Term Illness • Disaster • Loss of Records • Reliance on Professional Advice • Honest Mistake

Three kinds of penalty relief will be discussed in this manual:

1. Reasonable Cause
2. Administrative Waiver and/or First Time Abatement (a type of administrative abatement)
3. Statutory Exception

IRS PRACTICE UNIT: REASONABLE CAUSE AND GOOD FAITH

The IRS has updated its Practice Unit on the reasonable cause defense to certain penalties. This Practice Unit provides auditors with information on how to determine whether a taxpayer has a reasonable cause defense to a proposed penalty. The IRS develops Practice Units which serve as both job aids and training materials on tax issues for IRS auditors (**www.irs.gov/businesses/corporations/practice-units**). These practice units are not official pronouncements of the law and cannot be used as such; however, these units provide a general discussion of concepts or processes the Service employs when handling certain operational aspects.

The value of these Practice Units can be seen in a review of the Practice Unit itself. One of the challenges that a request for reasonable abatement presents is understanding how to present the request itself. The unit is divided into seven sections:

1. General Overview
2. Relevant Key Factors
3. Detailed Explanation of the Concept
4. Index of Referenced Resources
5. Training and Additional Resources

6. Glossary of Terms and Acronyms

7. Index of Related Practice Units

Reasonable cause is an important part of penalty administration for the Internal Revenue Service. Statutorily certain penalties are not imposed if the taxpayer can prove "reasonable cause" for the return position giving rise to the penalty ("reasonable cause defense"). Penalties that have a reasonable cause defense include:

1. Accuracy Related Penalties Imposed Under IRC Sec. 6662

2. Civil Fraud Penalties pursuant to IRC Sec(s). 6663 and 6664(d)

3. Erroneous Claims for Refund found in IRC Sec. 6676(a)

4. Failure to File and/or pay under IRC Sec. 6651

5. Understatement of taxpayer’s liability by a return preparer IRC Sec. 6694

The primary standard for reasonable cause is that the taxpayer acted in good faith or that the failure was not a result of willful neglect. Whether a reasonable cause defense has merit will be determined on a case-by-case basis, as determined by the facts and circumstances.

As demonstrated by the Practice Unit information, the auditor who is charged with determination of whether there is in fact reasonable cause should determine the extent of the effort that the taxpayer made in reporting their correct tax liability. The examples provided by the Practice Unit should be used when possible using your facts and circumstances.

Example 1. On their return, a taxpayer reports amounts from an erroneous information return but does not know the amounts are incorrect. This type of error may indicate that the taxpayer has reasonable cause for reporting the incorrect amounts on their return. However, there must be additional facts suggesting the taxpayer made a reasonable effort to ascertain the correct amounts.

Example 2. On their return, the taxpayer makes an isolated computation or transposition error. This type of error may indicate the taxpayer's good faith effort to report their proper tax liability.

Additional issues that we will discuss in the text reflect the IRS’s attitude in general regarding standards of care by the taxpayer and depth of knowledge by the taxpayer. A frequent defense used by the taxpayer is the reliance on a “tax professional.” The auditor reviewing the request for reasonable cause abatement based on the reliance standard should consider whether:

- The taxpayer's reliance on the advice of a tax advisor was objectively reasonable

- The taxpayer provided their tax advisor with all the necessary information to evaluate the tax matter

- The tax advisor had enough knowledge and expertise related to the tax matter to provide advice.

- The taxpayer "actually relied" on their tax advisor's advice.

- The taxpayer exercised the care that a reasonably prudent person would have used under the circumstances when relying on the tax advisor's advice.

There are two cases in particular that are salient regarding the issues associated with the reliance on the professional:

- In *Whitsett v. Comm.* (T.C. Memo 2017-100), the IRS assessed the substantial underpayment penalty because of numerous errors by the tax practitioner. The tax preparer reported a large stock gain in 2011 when it was properly includable in 2012. The court found that the practitioner was a "competent professional" in spite of the errors. The taxpayers had a reasonable belief that the practitioner was competent because he had served the taxpayer for many years with no filing issues.

- In *Kauffman v. Comm.* (T.C. Memo 2017-38), the practitioner defense failed. The request for abatement failed not because the practitioner was incompetent but because the taxpayer failed to substantiate the deductions due to inadequate records, i.e., a failure of the requirements as noted in item 2 above.

It is more difficult to assert reasonable cause in cases of late filing or late payment. However, auditors are instructed that they should consider factors that might excuse late filing or late payment, such as whether the taxpayer's records were unavailable (for example, due to illness, disaster, or casualty) or whether there was a law change of which the taxpayer could not reasonably have been expected to be aware. While a taxpayer's forgetfulness is not generally a basis for reasonable cause, it could be however, if the forgetfulness is due to a medical reason (e.g., the taxpayer has dementia).

The IRS uses a penalty abatement support decision tool named the Reasonable Cause Assistant (RCA). Reasonable Cause arguments are most frequently denied for two reasons:

1. The IRS has overlooked the totality of the argument – When making a RC request it is important that the totality of the request is apparent.

EXAMPLE: Reasonable Cause rejection due to inaccuracy regarding the cause

Due to illness, a taxpayer turned the filing of the tax return over to their tax professional. The system denied the request based on reliance on the professional rather than the medical reason, which was the primary reason for the failure.

2. The request was incomplete—in making the RC request, not enough information was provided.

EXAMPLE: Reasonable Cause rejection due to incompleteness of the request

The request states that the taxpayer turned the information over to a tax preparer (reliance on a professional) but fails to mention other pertinent information such as the taxpayer's eligibility for the first time abatement, the taxpayers incapacity or emotional distress or lack of financial knowledge.

It is important to prepare a concise, well-reasoned request which highlights the issues for the failure. Furnishing incomplete or haphazard information will only distract the IRS and lead to denials. Establishing reasonable cause requires documenting that the taxpayer used ordinary care and prudence but was still unable to comply, and the failure to comply was thus a result of an unforeseen circumstance or factors beyond the taxpayer's control.

RETURN PENALTY ABATEMENTS

An understanding of Form 1040 penalties cannot be addressed without consideration of the IRS's penalty abatement procedures. Each penalty can be abated not only on the particularities of the penalty, but also on consideration of the general abatement procedures.

The Internal Revenue Manual (IRM) Part 20 is available at **www.irs.gov**. Return related penalty discussions can be found in the IRM 20.1.5.4.2. When requesting abatement, it is important to address the most recent IRM procedure when requesting an abatement. This section was last updated on October 19, 2020.

When requesting an abatement, citation of both the IRC section number and the IRM procedure will assist in moving the case forward. This is especially critical, as the IRS increasingly relies on agents with less training as they are moved to the frontline. Most training for a new agent relies on IRS resources—particularly the IRM. The IRM will assist these new agents in developing the components of the penalty based on the information which they have a greater understanding.

EXAMPLE: Penalty Abatement Cross-Reference to IRM Section		
Penalty	**Descriptions**	**IRM**
IRC Sec(s). 6662(b)(1) and 6662(c)	Negligence or Disregard of the Rules and Regulations	20.1.5.8.1 20.1.5.8.2
IRC Sec(s). 6662(b) (2) and 6662(d)	Substantial Understatement	20.1.5.9.1
IRC Sec(s). 6662(b)(2) and 6662(d)	Substantial Valuation Misstatement	20.1.5.10

When addressing a penalty assessment, the abatement procedures should be considered. The current estimate is that the IRS assesses about 40 million civil penalties per year, with an estimated 4.4 million of those abated based on taxpayer request.

An abatement requires a reasonable cause (a more detailed discussion proceeds this section). The standard to qualify for reasonable cause is that the taxpayer did everything he or she could (the prudent person standard) but was still unable to comply with the law. Those standards are delineated by the IRM. The IRS has an administrative process of penalty abatement. Simply stated, the taxpayer was in error—they made a mistake. The administrative abatement is discussed in the following section.

In the event the taxpayer is unable to meet the reasonable cause threshold, it will be necessary to determine whether the appeal process could solve the issue.

FIRST-TIME ABATEMENT (FTA) AND OTHER ADMINISTRATIVE RELIEF

The IRS can provide administrative relief from a penalty under its program titled First-Time Abatement (FTA). To be eligible for the FTA, a taxpayer must qualify as follows:

1. He or she didn't previously have to file a return or had no penalties for the three tax years prior to the tax year in which the penalty was levied.

2. The taxpayer filed all currently required returns or filed an extension of time to file.

3. The taxpayer already paid or has arranged to pay any tax due.

If qualifying criteria are met, the IRS provides administrative relief (FTA) from the following penalties: (see IRM 20.1.1.3.3.2.1)

1. Failure to file (FTF) penalty under IRC Sec. 6651(a)(1), 6698(a)(1), or 6699(a)(1),

2. Failure to pay (FTP) penalty under IRC Sec. 6651(a)(2) and/or 6651(a)(3), and

3. Failure to deposit (FTD) penalty under IRC Sec. 6656.

The Reasonable Cause Assistant (RCA) is also designed to identify FTAs. Do not be confused by the name of the tool; abatement does not require that the taxpayer had a reasonable cause for the error.

Administrative relief is based on the policy of the IRS to act in the best interest of tax administration. The author prefers to think of FTA as an IRS policy which recognizes that people are human and sometimes make mistakes. An interesting part of FTA is that the forgiveness can be the result of the taxpayer's negligence. If the taxpayer meets the administrative requirements of FTA, the IRS's policy is to grant the abatement.

The RCA struggles in determining whether the taxpayer has complied with all their filing requirements. The process requires a Tax Assistor (TA) to manually determine filing status for the taxpayer. If the taxpayer has been denied an FTA, it is possible that a filing status check was incorrect due to this manual process and will require some nudging/review to obtain the FTA.

Many IRS oversight organizations complained that the IRS failed to offer FTA relief to eligible taxpayers. The IRS currently seems to be willing to approve an FTA even when the taxpayer is not eligible based on a plain reading of the policy. A review of the IRM 20.1.1.3.3.2.1 will find this example that appears to guide the service to resolve any doubt in the favor of the taxpayer.

EXAMPLE: Penalty Relief IRM Illustrations

IRM Example 1: If considering penalty relief on May 25, 2017, and the taxpayer otherwise meets FTA criteria, but we have no record their 2016 Form 1040 nor an extension of time to file has been filed, consider the taxpayer current for the 2016 Form 1040.

IRM Example 2: When determining if the taxpayer has paid, or arranged to pay, any tax currently due, consider the taxpayer current with this requirement if he or she has an open installment agreement and is current with his or her installment payments.

If the taxpayer has received incorrect oral advice from the IRS, the taxpayer may qualify for administrative relief. When receiving oral advice, it is always in the best interest of the taxpayer to document that guidance. Requesting this type of abatement can be an extreme challenge to obtain.

FILING AN APPEAL

The IRS has developed a "penalty appeal eligibility" assist tool which can be found at **www.irs.gov/appeals/penalty-appeal**. If the IRS has denied the request for an abatement of a penalty, an appeal can be filed if all the following have occurred:

1. A letter was received from the IRS assessing a failure to file and/or failure to pay penalty for an individual or business tax account,

2. A written request was sent to the IRS asking them to remove the penalty,

3. The IRS denied the request to remove the penalty (penalty abatement), and

4. A Notice of Disallowance, which grants appeal rights, was received.

There are circumstances which are beyond a planner's control that the IRS will consider (note, however, items 3 and 4 are not normally successful):

1. Death, Serious Illness (such as COVID-19) or Unavoidable Absence (IRM 20.1.1.3.2.2.1). To use this exception for an individual, it must affect the taxpayer or the taxpayer's immediate family.

2. Fire, Casualty, Natural Disaster, or other Disturbances (IRM 20-1.1.3.2.2.2). If the taxpayer is located in a disaster area, he or she is defined by IRM 25.16.1.2 as an affected person.

3. Unable to Obtain Records (IRM 20.1.1.3.2.2.3). This is not an issue of the records in the hands of someone who will not produce the records, e.g., prior accountant would not return records of prior client. It is difficult to support this position.

4. Mistake Was Made (IRM 20.1.1.3.2.2.4). May be a supporting factor if additional facts and circumstances support the determination that the taxpayer exercised ordinary business care.

5. Erroneous Advice or Reliance (IRM 20.1.1.3.2.2.5). The taxpayer may try to establish reasonable cause by claiming he or she relied on another party to comply on his or her behalf. Generally, this is not a basis for reasonable cause, particularly for filing or paying obligations, since the taxpayer is responsible for meeting his or her tax obligations and that responsibility cannot be delegated.

There are other standards indicated in the IRM, including forgetfulness. In most situations the IRS/Appeals will maintain that the taxpayer failed to exercise reasonable care.

OBSERVATION: Obtaining penalty relief is extremely difficult at most levels of the IRS. Always consider that, in a bureaucracy, saying no is easier than saying yes. FTA or reasonable cause is substantially easier than appealing and attempting to use the previously noted exceptions. Do note that your author has filed penalty appeals over the years for the IRS's failure to recognize reasonable cause.

FAILURE TO FILE PENALTY OR LATE FILING (FTF)

The failure to timely file a return may subject a taxpayer to a penalty based on the amount of tax due on the return. A taxpayer who is overpaid will not be subject to a late filing penalty. The amount of the penalty will be the greater of—

1. A combined penalty of 5% per month (4.5% late filing and 0.5% late payment), but not for more than a total of five months, which will limit the late filing penalty to 22.5%, or
2. A penalty of 15% per month (capped at 75%) if the return is fraudulent.

NOTE: If the return is 60 days or more late, the penalty is the lesser of $435 for returns required to be filed in 2021 or the balance due.

There are reasonable cause exceptions to the late filing penalty. An expanded discussion of some of those exceptions appeared earlier in this chapter.

COURT CASE: *Intress*, was a case of late filing. IRC Sec. 6651(a) abates the penalty in the event the late filing is due to reasonable cause. The taxpayers argued that there was an eligible exception under IRC Sec. 6651(a), as their tax preparer failed to file an extension on their behalf. It was determined that the preparer failed to file the extension due to a clerical error. (*Intress*, DC TN 08/02/2019, 124 AFTR 2d 2019-5118)

The court said that the taxpayers failed to exercise ordinary business care for the extension of the return. Despite the fact they had hired a tax professional, it was the taxpayers' responsibility to ensure the extension was filed. This clearly demonstrates the need to be communicative with your client, advising them of whatever actions have been taken on their behalf.

In *Laidlaw*, the district court also rejected the taxpayers' argument that they were entitled to first-time penalty relief under the IRM. As the IRS pointed out, the IRM is a policy guide to a governmental agency and does not entitle a taxpayer to judicial relief. (*Laidlaw*, TC Memo 2017-167)

FAILURE TO PAY PENALTY (FTP)

The failure to pay penalty will accumulate at a rate dependent on the circumstance under which the underpayment occurred. However, a late payment penalty in total will not exceed 25%:

1. The FTP penalty of tax as shown on the return at the rate of 0.5% of the unpaid taxes for each month or part of a month the tax remains unpaid. In the event voluntary payments are being made, designate payments to tax, penalty, and interest in that order to reduce penalty amounts.
2. If the tax remains unpaid by the due date in a notice or letter that IRS sends to the taxpayer, the FTP penalty is 0.5% of the tax you didn't pay timely for each month or partial month that you don't pay after the due date.
3. If the tax return *is filed on time* as an individual and there is an *approved* payment plan, the FTP penalty is *reduced* to 0.25% per month (or partial month) during the approved payment plan.

4. If the taxpayer fails to pay the tax in 10 days after getting a notice from IRS with a notice of intent to levy, the FTP penalty is 1% per month or partial month.

OBSERVATION: On March 17, 2021, Treasury and the IRS announced the extension of the filing and payment deadlines from April 15, 2021 to May 17, 2021 for Form 1040. It should be noted that the extension of payment deadline for 2020 did not apply to estimated payments for the 2021 tax year (See additional information in estimated late payment penalties later in this chapter).

Any kind of payment agreement, such as an installment agreement, will be subject to the FTP penalty until any unpaid balance has been satisfied.

EXAMPLE: Failure to Pay Penalty Assessments

Scenario 1: A taxpayer enters into a 36-month payment agreement. The FTP penalty will be applied to any unpaid balance each month. The rate of the penalty will be determined based on whether the payment agreement was part of the filing process, i.e., 0.25% versus 0.5%.

Scenario 2: A taxpayer enters into a 60-month payment agreement, subject to a FTP rate of 0.5%. The failure to pay penalty will only apply to the first 50 months from the initial date of assessment. After the 50-month period has expired, only interest will be due on any unpaid balance.

ABATEMENT OF FAILURE TO FILE OR FAILURE TO PAY PENALTIES UNDER IRC SEC. 6651

The FTA is the IRS's equivalent of a get out of jail free card; however, using that card may not be in the taxpayer's best interest. Consider the taxpayer's other options if they have any, such as reasonable cause. As previously stated, the FTA *is not* a unilateral abatement of failure to file penalties, as there are only certain narrow exceptions.

How to File

The following steps should be taken when filing for an FTA. Note that it is possible to obtain a late filing and late payment penalty for the same failure

1. Attach any justification for the late filing to the late-filed return. Often this request will be processed by the IRS without generating a notice. It should be noted that IRS has been particularly attentive to this issue lately. Returns have been processed by the service recognizing and granting FTA.

2. Cite applicable law and authority, citing any IRM procedures when requesting nonassertion or abatement.

3. Establishing an installment agreement ASAP can slow down the accrual of the failure to pay penalty in periods of financial hardship.

4. Reasonable cause is often subjective. Tell any story enough times and you will find somebody who finds the story compelling.

Due to limited staffing, IRS appeals can often be an expedient way of reaching a resolution. The Collection Appeals Program (CAP), IRM 8.24.1. CAP is binding on both parties, i.e. nobody gets to change their mind.

DISHONORED CHECK OR PAYMENT

A penalty is assessed in the event of a dishonored payment without regard to the form of payment per IRC Sec. 6657. There is a RC abatement process for this penalty also:

1. If the payment is $1,250 or more, the penalty will be 2% of the dishonored payment.

2. For payments of less than $1,250, the penalty is the payment amount or $25, whichever is less.

SUBSTANTIAL UNDERPAYMENT PENALTY UNDER IRC SEC. 6662

IRC Sec. 6662 imposes an accuracy-related penalty of 20% for underpayments of tax that are the result of a specified collection of taxpayer behaviors which result in an underpayment. These specified behaviors are—

1. Negligence of the rules or regulations

2. Disregard of the rules or regulations

3. Any substantial understatement of income tax,

4. Disallowance of claimed tax benefits by reason of a transaction lacking economic substance, or

5. The nondisclosure of any foreign financial asset understatement.

It is critical to understand the definition of “disregard of the rules or regulations.” To raise to the level of disregard, the taxpayer must be careless, reckless, and intentional. Negligence will include any failure to—

1. make a reasonable attempt to comply with the Internal Revenue Code,

2. exercise ordinary and reasonable care in the preparation of an income tax return, or

3. keep adequate books and records to substantiate items included in the return.

The substantial understatement provision is the most often assessed penalty of IRC Sec. 6662 and is often assessed mathematically without considering if the taxpayer “disregarded the rules.” The National Taxpayer Advocate (NTA) has reported that the IRC Sec. 6662 penalty is the most often litigated penalty. During June 2015–May 2017, the federal courts issued over 260 opinions involving IRC Sec. 6662.

Any time the amount of the understatement is greater than $5,000 or 10% of the tax shown, the taxpayer is considered to have made a substantial understatement, thus subjecting them to the 20% penalty.

OBSERVATION: This part of IRC Sec. 6662 has become an automatic part of IRS assessment procedures. In a report to congress by the Tax Payer Advocate’s office, Nina Olson indicated that the Service has been excessively assessing the penalty. Her report stated that a full 20% of the cases brought to court by the taxpayer that included a Section 6662 penalty were abated by the court. It can be expected that any CP-2000 notice proposing an assessment under the substantial understatement criteria of IRC Sec. 6662, will include the penalty as part of its assessment—and often incorrectly. Consideration should be given to requesting abatement of the penalty.

The IRS bears the initial burden of proof to demonstrate when a taxpayer is subject to the penalty. Once the IRS has "satisfied" that burden, the taxpayer will solely be responsible to produce the necessary information to prove they have complied with the necessary elements which are the opposite of what constitutes negligence in that they made a—

1. Reasonable attempt to comply,

2. They exercised ordinary and reasonable care, and

3. They kept adequate books and records.

IRC Sec. 6662 can be overcome with a reasonable cause defense. The Regulations state that the taxpayer may overcome the presumption of substantial negligence, reasonable cause, by demonstrating that there was a (Reg. §1.6664-4)—

1. reasonable misunderstanding of law or fact, or

2. the experience, knowledge, or education of the taxpayer, or

3. isolated computational or transcriptional error, or

4. reliance on an informational return (*McGuire* case discussed later in this chapter), or

5. reliance on the advice of a professional tax adviser (*Whitsett* or *Kauffman* case discussed earlier in this chapter), or

6. reliance on erroneous information.

The IRS has often been challenged on procedural aspects of the assessment of the Section 6662 penalty with little or no success on the part of the taxpayer. However, a victory for the taxpayer was received in *Hommel* (TC Memo 2020-4) due to procedural failures on the part of the IRS. Since a Section 6662 assessment requires that a supervisor approve the penalty, the taxpayer was successful in *Hommel* because the IRS was unable to produce the penalty approval form supporting the chain of command. While this was not a conclusive victory for taxpayers in general, it provides some insight of how a taxpayer could prevail in a procedural case.

The failure to comply with all the requirements makes for a difficult if not impossible case. When attempting to obtain a Section 6662 penalty abatement, the demonstration of all three requirements is critical to a successful defense.

OBSERVATION: Guidance for penalty relief can be found in the Internal Revenue Manual (IRM) 20.1.1. With the large number of Section 6662 penalties that are being assessed by the IRS, often without due consideration, these types of penalties should be closely monitored. The concise demonstration of the "ordinary care" by the taxpayer can lead to a successful abatement of this penalty. It should not go unnoticed that in court, the IRS wins about 80% of the time. However, this should not be a deterrent, as the IRS has a history of being extremely cautious about taking cases to court they doubt they can win, with many of these Section 6662 cases settled by mutual agreement or appeals.

The nonreceipt of an information return and the subsequent non-inclusion of the item in the return is one of the most frequent precursors of the substantial understatement penalty. At issue in *McGuire* [149 T.C.

No. 9 (2017)] was the failure of the taxpayers to receive Form 1095-A. The court ruled that because the taxpayers did not receive their information return, and thus did not have notice of the income because payments were received by the insurance company and not the taxpayers, and the taxpayers had reasonably relied on a third party (the marketplace) to adjust their eligibility for the tax credit, the taxpayers showed reasonable cause, and the accuracy-related penalty was not sustained.

For years, tax practitioners have argued that the IRS has repeatedly violated the procedural requirements for assessing a Section 6662 penalty. Under IRC Sec. 6751(b)(1), there is a requirement that the Section 6662 penalty assessment must be “signed off” by the IRS “examiner’s” immediate supervisor no later than the date the Service issues the notice of deficiency. While many courts have determined that the procedural business rules of the IRS comply with this requirement of IRC Sec. 6751(b)(1), the 2nd Circuit Court of Appeals has not been as willing. The most likely outcome of this controversy is a modification of the IRS’s assessment procedures of Section 6662 penalties. However, this leaves many substantial understatement penalties assessed prior to 2019–2020 subject to being overturned by the courts.

Understanding the IRS’s interpretation of IRC Sec. 6662’s provisions is difficult and complicated. Knowledge of the procedures and administration of the penalty can be helpful. An article in the AICPA publication The Tax Advisor regarding IRC Sec. 6662 can be helpful during the request for abatement process (visit **www.thetaxadviser.com/issues/2018/dec/avoiding-accuracy-related-penalty-reasonable-cause-exception.html**).

Disclosure to Avoid Section 6662 Penalties

The accuracy-related penalty cannot be imposed if the return position meets certain tax authority statements (more likely than not) aka the substantial authority standard. Standards for the abatement of Section 6662 penalties can be found in Reg. 1.6664-4.

To avoid an assessment of a Section 6662 penalty, consider the IRS cannot impose an accuracy-related penalty if the tax return position is properly disclosed and/or if there is a reasonable basis for the position (at least a 20% chance of being sustained on its merits). Disclosure on Form 8275 or 8275-R if applicable.

UNDERPAYMENT (ESTIMATED) TAX PENALTY

The amount of the estimated penalty is based on the due date of the “estimate failure” and the IRS interest rate applicable for that period. A taxpayer is required to pay at least 90% of their total tax shown on the current return or 100% of the prior year. If the taxpayer is a “high-income” taxpayer ($150,000 AGI), the amount is 110%.

These installments are due on 04/15, 06/15, 09/15, and 01/15 (the following year). Certain taxpayers such as farmers, fisherman, and non-resident aliens are excepted from these rules. A taxpayer that is fiscal year will adjust the due dates accordingly.

PRACTICE NOTE: When the IRS extended the due date of returns to May 17, 2021 (IR 2021-59) but failed to adjust the due date of estimated payments, numerous practitioners were concerned about the application date of overpayments from the 2020 returns. In subsequent guidance, the IRS confirmed that any overpayment credited to estimates by a 2020 return would be credited as if it had occurred on April 15, 2021. There is an exception for overpayments that were created as a result of extension payments that may have been made by the taxpayer on May 17, 2021. To that extent, the IRS provided several examples at **www.irs.gov/forms-pubs/electing-to-apply-a-2020-return-overpayment-from-a-may-17-payment-with-extension-request-to-2021-estimated-taxes**.

EXAMPLE: IRS examples of applying the Section 6402(b) rules

On April 12, 2021, the IRS provided examples of the application of the rules provided by IRC Sec. 6402(b) and Reg. §301.6402-3(a)(5).

Example 1: Assume that an individual taxpayer: (a) owes $40,000 in income tax for 2020; (b) made no payments toward that tax by April 15, 2021; (c) owes $10,000 for the first estimated tax installment for 2021 due on April 15, 2021; and (d) paid $50,000 toward the 2020 tax on May 17, 2021. As a result, the taxpayer has a $10,000 overpayment for 2020.

Because the payment was not made by April 15, 2021, no overpayment existed as of April 15, 2021, and the overpayment would not be available for crediting on April 15, 2021. Instead, the overpayment would be credited against the 2021 estimated tax installment as of May 17, 2021, the date of payment. The taxpayer's $50,000 payment on May 17, 2021, caused the taxpayer's payments to exceed the taxpayer's liabilities.

Therefore, the taxpayer became overpaid on May 17, 2021, and May 17, 2021 is the date the $10,000 overpayment is available for crediting, even if the $50,000 payment made on May 17, 2021, was paid with an application to automatically extend the due date to file the 2020 return to October 15, 2021. An extension of time to file has no effect on either the date of payment or the date on which an overpayment exists.

Example 2: Assume that an individual taxpayer: (a) owes $40,000 in income tax for 2020; (b) prepaid $40,000 of that 2020 tax during 2020; (c) owes $10,000 for the first estimated tax installment for 2021 due on April 15, 2021; and (d) paid $10,000 toward the 2020 tax on May 17, 2021.

As a result, the taxpayer has a $10,000 overpayment for 2020. Because the taxpayer's payments as of April 15, 2021, did not exceed the taxpayer's liability, no overpayment exists as of April 15, 2021, and the overpayment is not available for crediting on April 15, 2021. The taxpayer's $10,000 payment on May 17, 2021, caused the taxpayer's payments to exceed the taxpayer's liabilities.

Therefore, the taxpayer became overpaid on May 17, 2021, and May 17, 2021 is the date the $10,000 overpayment is available for crediting, even if the $10,000 payment made on May 17, 2021, was paid in conjunction with an application to automatically extend the due date to file the 2020 return to October 15, 2021. An extension of time to file has no effect on either the date of payment or the date on which an overpayment exists.

Example 3: Assume that an individual taxpayer: (a) owes $40,000 in income tax for 2020; (b) prepaid $45,000 of that 2020 tax during 2020; (c) owes $10,000 for the first estimated tax installment for 2021 due on April 15, 2021; and (d) paid $5,000 toward the 2020 tax on May 17, 2021. As a result, the taxpayer has a $10,000 overpayment for 2020. Because the taxpayer's payments as of April 15, 2021, exceeded the taxpayer's liability by $5,000, an overpayment of $5,000 existed on April 15, 2021, and that overpayment is applied against the first 2021 estimated tax installment as of April 15, 2021. The remaining $5,000 of the $10,000 overpayment is attributable to the payment made on May 17, 2021, which is when this amount would be credited against the first 2021 estimated tax installment, even if the $5,000 payment made on May 17, 2021, was paid with an application to automatically extend the due date to file the 2020 return to October 15, 2021. An extension of time to file has no effect on either the date of payment or the date on which an overpayment exists.

To avoid the penalty, taxpayers have several safe harbor options:

1. Arrange their withholding to equal the safe harbor thresholds. Withholding is considered to occur in equal installments through the year unless the taxpayer provides information to the contrary.

2. Pay each required installment, 25%, by the required date. There is an annualization option which will be explained in detail later.

3. Meet one of the exceptions to the rules, or

4. Obtain a waiver.

Consider using the annualized method of calculating the penalty. This method will require the taxpayer to complete Schedule AI on Page 4 of Form 2210, indicating the taxpayer's income for each reporting period. Any underpayment will be based on when payments are made and when the income is earned. Some tips for completing Form 2210, annualized income exception:

1. Determine where any S corporation or partnership earnings were distributed from. Those distributions from AAA or partnership capital are not income.

2. Flow thru items such as sale of assets, interest or dividends will be considered to be earned when they are "income to the entity".

3. Careful analysis of the income, especially of an S corporation can be a penalty saver for the late estimated tax penalty.

EXAMPLE: Determining Quarterly Income

When analyzing Jon's income, it was determined that his taxable income was $100,000, earned as follows: Q1: 0%; Q2: 20%; Q3: 30%; and Q4: 50%

Each quarter will be attributed its respective income versus 25% of the return's taxable income, reducing the amount of the first three quarters estimate due in our example.

There are exceptions to the underestimate tax penalty:

1. The taxpayer didn't make a required payment because of a casualty event, disaster, or other unusual circumstance and it would be inequitable to impose the penalty, or

2. The taxpayer retired (after reaching age 62) or became disabled during the tax year or in the preceding tax year for which they should have made estimated payments, and the underpayment was due to reasonable cause and not willful neglect.

FAILURE TO WITHDRAW REQUIRED MINIMUM DISTRIBUTONS (RMD)—EXCISE TAX

A penalty of 50% of the RMD is assessed if an individual does not make an RMD. The penalty is assessed on the shortfall [IRC Sec. 4974(a)]. The IRS has the authority to waive a penalty if a taxpayer can establish the shortfall was due to a reasonable error and steps are taken to remedy the shortfall [IRC Sec 4974(d); Reg. 54.4974-2, (Q-7)]. To request a waiver, complete Form 5329 (Tax Year 2020), Part IX:

1. Line 52 indicate the total amount of RMD for the tax year.

2. Line 53, the amount actually distributed from the IRA

3. Line 54:

    a. Enter “RC” and the amount of the waiver in parentheses on the dotted line next to line 54. The request for waiver should be for the entire amount of the penalty. Your tax software will normally have an entry for this amount, completing the required statement.

    b. Subtract the waiver request amount from the total shortfall and enter the result.

4. Line 55, complete as instructed, and pay any tax due.

The IRS will review a waiver request and determine what penalty if any is warranted. In the event the IRS has a question regarding the request, they will forward an inquiry to the taxpayer. If a waiver request is wholly or partially denied, the IRS will provide a notice indicating the penalty amount due and the date payment is expected.

OBSERVATION: There is a belief, particularly by investment advisors, that many RMDs will be missed for 2021, and perhaps for several more years, as a result of the elimination of the RMD requirement for 2020 plus the change to the RBD as a result of the SECURE Act (see Chapter 16 for RMD details).

Practitioners are urged to be mindful of RMDs for 2021. In the event an RMD is required but not made, self-report as indicated on Form 5329 and request the RC abatement. RC abatements become more challenging to obtain when the IRS gets involved on a more personal level.

The IRS will automatically waive the penalty if [Reg. 54.4974-2, A-7(b)]—

1. The payee is an individual who is the sole beneficiary of a deceased owner’s retirement account,

2. The payee’s RMD amount for a calendar year is determined under the life expectancy rule where death occurs before the owner’s RBD, and

3. The entire benefit is distributed by the end of the fifth calendar year following the year of death.

PENALTY PROVISIONS FOR TRADITIONAL IRA AND QUALIFIED RETIREMENT PLANS

Premature distributions, a 10% penalty, or excise tax, must be paid on early distributions (amounts distributed before a participant reaches age 59½) from qualified plans and IRAs [IRC Sec(s). 72(t)(1) and (2)(A)(i)].

Exceptions

The following Example lists exceptions to the penalty.

Example: Early Distribution Penalty Tax Exceptions			
Exceptions to Penalty Tax	**IRAs, ROTH IRA, SIMPLE IRA, SEP IRA**	**Qualified Plans**	**Tax Deferred Annuities**
1. Made upon the death to a beneficiary or to an estate of an IRA owner on the death of the IRA owner without regard to the owner's age at death [IRC Sec. 72(t)(2)(A)(ii)].	X	X	X
2. Attributable to the employee becoming disabled as defined in IRC Sec. 72(m)(7).	X	X	X
3. Part of a series of substantially equal periodic payments.	X	Must separate from service	X
4. Medical expenses for the year in excess of AGI threshold per IRC Sec. 213(f).	X	X	
5. Made on account of a federal levy—only if the plan or IRA is actually subjected to levy.	X	X	
6. Qualified Reservist distributions.	X	X	
7. Made to an employee after separation from service after reaching age 55 (age 50 for qualified public safety employees).		X	
8. Paid to an alternative payee pursuant to a qualified domestic relations order (QDRO).	X	X	X
9. First-time home purchase up to $10,000.	X		
10. Payments allocated to investment in the contract before August 14, 1982.			X
11. COVID-19 related distributions to affected taxpayers up to $100,000 (CARES Act) 2020 Only	X	X	X
12. Distributions that qualify as Qualified Disaster Distributions by affected taxpayers up to $100,000 (Disaster Relief Act)	X	X	X
13. Qualified birth and adoption distributions to individuals totaling $10,000 or less within the year (SECURE Act)	X	X	X

Disability is defined as unable to engage in any substantial gainful activity because of any medically determinable physical or mental impairment that can be expected to result in death or be of a long-continued and indefinite duration:

1. It is best to attach a doctor's statement to the return because proof must be furnished

2. Substantially gainful activity refers to an activity or a comparable activity in which the individual customarily engaged in prior to the disability or prior to retirement if retired at the time the disability arose [Reg. 1.72-17A(f)(1)].

OBSERVATION: The IRS has notified trustees/administrators that an indication of a disability payment indicator on Form 1099-R, Code 3, should normally not be made. Unless the beneficiary is age 59½, eligible for a "normal distribution" Code 7, 1099-R, Box 7, the administrator/trustee will complete 1099-R, Box 7, with Code 1. The taxpayer will be required to prove the eligibility for the disability exception to the IRS by completing Form 5329 to claim the exemption from the 10% excise tax penalty.

CLAIMING THE SECTION 72(T) EXCEPTION REQUIRES COOPERATION WITH THE IRS

Frequently taxpayers view the request for a Section 72(t) exception as a mere formality. In *Kramer* (TC Memo 2021-16), the taxpayers failed to cooperate with the IRS to determine if they were in fact eligible for a Section 72(t) exception of the 10% premature distribution penalty. The court allowed the IRS to assess the penalty as a result of the taxpayer's failure to cooperate.

QUALIFIED BIRTH AND ADOPTION DISTRIBUTIONS (QBA)

As a result of the SECURE Act, for tax years beginning after December 31, 2019, a provision was added allowing an exception to the premature distribution penalty on distributions by adding a provision for Qualified Birth and Adoption (QBA) Distributions (QBA). With the provision added by the SECURE Act, a taxpayer who participates in a retirement plan which allows QBA distributions may receive that distribution in an amount of up $5,000 per parent, per newly born or adopted child, and the distribution *will not* be subject to 20% withholding (when made from a Qualified Plan), but at a rate of 10% that can be elected to be waived by the beneficiary.

The recipient has a limited one-year rollover period for a QBA. For purposes of complying with the general rule which allows only one indirect IRA rollover within a one-year period (the "one-rollover" rule), a taxpayer may have to take into account a rollover of a QBA distribution from a traditional IRA to another traditional IRA (or from a Roth IRA to a Roth IRA). Under the one-rollover rule, a taxpayer generally may *not* roll over a current IRA distribution to another IRA tax free if—

1. the taxpayer received a previous distribution from any IRA during the one-year period preceding the current distribution, and

2. the taxpayer rolled over the previous distribution tax free to an IRA.

In the event the taxpayer has not recontributed/rolled over the distribution by the due date of the distribution year, the distributed amount must be included in the distribution year's return. If the amount is later recontributed/rolled over, an amended return can be filed to reflect the recontribution.

CHAPTER 5: ECONOMIC IMPACT PAYMENTS (EIPs)

Learning Objectives

Completion of this chapter will enable participants to—

- Explain the economic impact payments and their effects on 2021 tax returns.

WHAT'S NEW THIS YEAR

There have been three rounds of Economic Impact Payments (EIPs) now. Like the earlier two payments, 2021 returns will require a reconciliation to determine any underpayments.

ECONOMIC STIMULUS PAYMENTS—ROUND 3

As provided for by the American Rescue Plan Act of 2021 the third stimulus check, or EIP, direct deposits started arriving in March 2021. Eligible Americans automatically received the third EIP of up to $1,400 for individuals or $2,800 for married couples, plus $1,400 for each dependent claimed on a tax return (**www.irs.gov/newsroom/updated-details-about-the-third-round-of-economic-impact-payments**).

Taxpayer's Who Did Not Get a Third Stimulus Check

U.S. Citizens or resident aliens did not receive the third EIP if their AGI exceeded—

- $80,000 for eligible individuals using other filing statuses, such as single filers and married people filing separate returns.
- $160,000 if married and filing a joint return or if filing as a qualifying widow or widower
- $120,000 if filing as head of household

Did Taxpayers Get Less Than the Full $1,400 EIP?

Many taxpayers received the full amount of $1,400, but only if their AGI was less than or equal to the following amounts based on the available tax return information:

- $150,000 if married and filing a joint return or if filing as a qualifying widow or widower received the full amount. Payments were phased out to ZERO if their AGI exceeded $160,000.
- $112,500 if filing as head of household, phased out to ZERO at $120,000, or
- $75,000 for eligible individuals using any other filing statuses, such as single filers and married people filing separate returns, were phased out to ZERO at $80,000.

How Did the IRS Determine Stimulus Check Eligibility?

The IRS applied information contained in any of the following sources:

1. The taxpayer's 2020 tax return.
2. If no tax return for 2020 filed, then the IRS used the taxpayer's 2019 tax return.

3. If there is no 2020 or 2019 tax return, but the individual registered for the first Economic Impact Payment using the special Non-Filers Portal in 2020, then the information contained therein was used.

4. If as of December 31, 2020, the taxpayer is a recipient of any of the following federal benefits:

    a. Social Security and Railroad Retirement Board benefits,

    b. Supplemental Security Income (SSI) and

    c. Veteran benefits recipients in 2020.

NOTE: Any Q&A topics referred to in this section can be found on the IRS's Economic Impact Payment Information Center at **www.irs.gov/coronavirus/economic-impact-payment-information-center**.

The March 2021 EIP was an advance payment of the 2021 Recovery Rebate Credit. The IRS was instructed to make an advance payment of the 2021 credit based on a hypothetical credit calculation for 2021 (or as applicable, 2018). The advance payment will reduce the 2021 credit that is available for 2021, but not below zero.

The following three key elements apply for the March 2021 EIP:

- **Income Phaseout Amounts Changed.** Payments begin to be reduced for individuals with adjusted gross income of more than $75,000 (or $150,000 if married filing jointly). The reduced payments end at $80,000 for individuals and $160,000 for married filing jointly. People above these levels will not receive any payment.

- **Payment Amounts are Different.** Most families will get $1,400 per person, including all dependents claimed on their tax return. Typically, this means a single person with no dependents will get $1,400, while married filers with two dependents will get $5,600.

- **Qualifying Dependents Expanded.** Unlike the first two payments, the third payment is not restricted to children under age 17. Eligible individuals will get a payment based on all their qualifying dependents claimed on their return, including older relatives like college students, adults with disabilities, parents, and grandparents.

ECONOMIC STIMULUS PAYMENTS—ROUND 2

Any U.S. citizen or U.S. resident alien was eligible for $600 ($1,200 for a joint return), plus $600 for each qualifying child, if the taxpayer(s) (and spouse if filing a joint return) weren't a dependent of another taxpayer on a 2019 tax return, had a social security number (SSN) valid for employment and an AGI that did not exceed:

1. $150,000 MFJ and Qualified Widower

2. $112,500 Head of Household

3. $75,000 all other filing statuses

However, taxpayers may be eligible to claim a Recovery Rebate Credit on line 30 of their 2020 tax returns. (Please refer to the 2020 Form 1040 instructions for more information.)

ECONOMIC STIMULUS PAYMENTS—ROUND 1

The IRS began issuing the payments in April 2020. The Service noted that no advances were made or allowed after December 31, 2020. Eligible taxpayers who filed tax returns for either 2019 or 2018 automatically received an EIP of up to $1,200 for individuals or $2,400 for married couples. Parents also received $500 for each qualifying child under the age of 17.

The IRS based the advance on either the taxpayer's 2019 or 2018 return. If at the time of processing the taxpayer had filed their 2019 return, the payment was based on the 2019 information. If the taxpayer had not filed for 2019, the payment was based on the taxpayer's 2018 return.

RECONCILIATION—ROUNDS 2 AND 1 COMBINED

There was no provision in the law that would require individuals who qualified for a payment based on their 2018 or 2019 tax returns, to pay back all or part of the payment, if based on the information reported on their 2020 tax returns—

1. The taxpayer received $500 for a child who, based on the 2018 or 2019 tax return, met the qualifying child requirements. If that child turned 17 in 2020 and no longer met the qualifying child requirements, the law did not provide a requirement to pay back the $500.

2. The taxpayer received a payment of $500 for a child who was claimed on taxpayer's 2018 or 2019 tax return, but the taxpayer did not claim the child on their 2020 tax return because the child's other parent claims the child, the taxpayer was not required to pay back the $500 even if the child's other parent claims $500 for the same child on his or her 2020 tax return.

However, the taxpayer was eligible to claim a Recovery Rebate Credit on line 30 of the 2020 tax return. Please refer to the instructions for the 2020 Form 1040 for more information.

NON-FILERS

People who receive Social Security retirement, disability (SSDI), survivor benefits, supplemental security income (SSI), Railroad Retirement benefits, or Veterans Affairs Compensation and Pension (C&P) benefits will receive a payment automatically [Rev. Proc. 2020-28] for EIP 1,2 and 3. New beneficiaries who began receiving Social Security or SSI after January 1, 2020, and didn't file a 2018, 2019, or 2020 return, should have used the non-filer tool. People whose income was below the filing threshold for 2018, 2019, and 2020 were able to use the non-filers tool available at **www.irs.gov/coronavirus/non-filers-enter-payment-info-here**.

Delinquent taxpayers who failed to file their 2018, 2019, or 2020 return *did not* receive an EIP.

An economic impact payment isn't taxable income to the recipient. It won't reduce the recipient's refund or increase the amount owed on the recipient's 2020 or 2021 tax return [Q&A-34].

While EIPs 1 and 2 were made in 2020/2021 (based on 2018 or 2019 returns), the credit will be reconciled on an individual's 2020 tax return. Notification of the payment was made via Notice 1444. Taxpayers should retain this notice for their 2020 tax records. The IRS made the status of the EIP available on its Where's My Refund Tool available at **www.irs.gov/refunds**.

Many taxpayers did not receive the credit for EIPs 1 and 2, and the 2020 return was used to reconcile payments made and not made. If filed properly, the reconciliation should be complete. However, there were and still are many taxpayers waiting for proper payments that were made as part of their 2020 return.

PAYMENT METHODOLOGY

Direct Deposit or Paper Check

The IRS made the payment electronically to any account to which the payee authorized, on or after January 1, 2018, the delivery of a refund of federal taxes or of a federal payment. Accordingly, the IRS stated it will deposit the payment directly into the bank account reflected on the return filed or mail a paper check to the address listed on the taxpayer's most recently filed return.

Pre-Paid Debit Card

The IRS made some economic impact payments on a prepaid debit card known as “The Economic Impact Payment Card.” These cards arrived in a plain envelope from “Money Network Cardholder Services.” The Visa name will appear on the front of the card; the back of the card has the name of the issuing bank, MetaBank®, N.A. Explanatory information will be included with the card, and more information can be found at **www.EIPcard.com**. Lost cards can be replaced through MetaBank Customer Service. The $7.50 fee will be waived for the first replacement.

WHO IS NOT ENTITLED TO THE EIP?

Taxpayers who *are not* entitled to the EIP include—

1. Taxpayers with income exceeding the AGI threshold.
2. Someone claimed as a dependent on someone else’s return.
3. Taxpayers without a Social Security number that is valid for employment.
4. Nonresident aliens.
5. Taxpayers who filed Form 1040-NR or 1040NR-EZ, Form 1040-PR, or Form 1040-SS for 2019 or 2020.
6. An incarcerated individual.
7. A deceased individual.
8. An estate or trust.

Payments to Decedents

An economic impact payment made to someone who died before receiving the payment should be returned to the IRS. The entire payment should be returned unless it was made to joint filers and one spouse was alive at the time of receipt. In that case, only the portion made on account of the decedent should be returned.

Payments to Incarcerated Persons

A person who is incarcerated doesn't qualify for an economic impact payment. Any payment received by an incarcerated person should be returned. For a payment made on a joint return where only one spouse is incarcerated, only the portion made on account of the incarcerated spouse needs to be returned [Q&A 14].

How to Return Payments

To return an economic impact payment made by a paper check, write “Void” in the endorsement section on the back of the check, and mail the voided Treasury check immediately to the appropriate IRS location listed on the IRS website. Do not staple, bend, or paperclip the check. Include a brief explanation of the reason for returning the check. (The author believes that mailing the check to the Service is a bad idea given the Agency’s current backlog. Consider using item number 2 below.)

If the paper check has already been cashed, or if the payment was made by direct deposit, submit a personal check, money order, etc., payable to “U.S. Treasury” to the appropriate IRS location listed on the IRS website. Write “2020EIP or 2021EIP” and the taxpayer identification number (Social Security number, or individual taxpayer identification number) of the recipient of the check. Include a brief explanation for returning the payment [Q&A-64].

SENIOR CONCERNS

Economic impact payments generally belong to the recipients, not to nursing homes and other facilities that provide care to the recipients [IR 2020-121].

Economic impact payments do not count as a resource for purposes of determining eligibility for Medicaid and other federal government assistance or benefit programs for a period of 12 months from receipt. They also do not count as income in determining eligibility for these programs [IR 2020-121]. Benefit recipients, such as nursing home residents of whose care is provided by Medicaid, do not have to turn over their economic impact payments.

PAYMENT/CLIENT ISSUES

Duplicate $500 payments

If a child's parents who are not married to each other both received a $500 payment for a qualifying child, neither of them has to pay back the $500.

Offset

Generally, EIPs will not be offset for federal or state debts. However, EIPs may be offset by past-due child support. The BFS will send a notice if a child-support offset occurs.

Did Not Get the Full Advance

If the taxpayer does not receive the full amount of the EIP, they will apply for the balance when they reconcile the credit on their 2020/2021 tax return.

Taxpayers Who Receive a Larger EIP Than They Should Have

There is no provision in the law that would require individuals who qualify for a payment based on their 2018, 2019, or 2020 tax returns to pay back all or part of the payment, if based on the information reported on their 2020 tax returns, they no longer qualify for that amount or would qualify for a lesser amount.

EXAMPLE: Taxpayer Receives a Larger EIP Than He Should Have

Jim received $1,400 for his child who, based on his 2020 tax return, met the qualifying child requirements. That child turned 17 in 2021 and no longer meets the qualifying child requirements. Jim will not be required to pay back the $1,400.

Variation: Jim received $500 for his child whom he claimed on his 2020 tax return. Jim did not claim the child on his 2021 tax return because the child's mother claims the child. Jim will not be required to pay back the $1,400 EIP even if the child's mother claims $500 for the same child on her 2021 tax return.

IRS Help

The Taxpayer Advocate Service (TAS) won't accept cases related solely to economic impact payments, because TAS assistance won't expedite or improve payment processing. However, TAS can address problems with returns filed for 2019 (or 2018 if the 2019 return is not filed), including identity theft, duplicate returns, and certain Return Integrity Verification Operation (RIVO) issues. These issues, which TAS routinely handles, typically stop both the taxpayer's refund and the economic impact payment. If TAS can resolve the return issue, it may result in the release of the payment.

Injured Spouse

Taxpayers who are married filing jointly with one spouse who filed an injured spouse claim (Form 8379) with the 2019 tax return (or the 2018 tax return if taxpayers haven't yet filed for 2019), half the total EIP will be sent to each spouse and only the liable spouse's EIP will be offset for past-due child support. There is no need to file another injured spouse claim for the EIP.

PLANNING TIP: Will There Be a Another Round of Economic Impact Payments? As of the publication of this manual, Congress continued to debate an additional round of funding for Economic Impact Payments and additional Pandemic Unemployment Assistance Funding. We will update when further information is available.

WHERE TO GO FOR MORE INFORMATION

- The Economic Impact Payment Center on the IRS's website:
- **www.irs.gov/newsroom/questions-and-answers-about-the-third-economic-impact-payment-topic-h-reconciling-on-your-2021-tax-return**
- **www.irs.gov/coronavirus/economic-impact-payment-information-center#reconciling**

CHAPTER 6: EDUCATION AND ABLE PLANNING

Learning Objectives

Completion of this chapter will enable participants to—

- Identify the deduction, credits, and investments allowable for education expenses.
- Describe savings opportunities and planning strategies related to financing the cost of school or using ABLE accounts.
- Identity tax-free grants under the CARES Act.

WHAT'S NEW

1. COVID relief impacts multiple areas relating to education
2. Emergency Student Grants and expanded debt relief provisions

EMERGENCY STUDENT GRANTS

The CARES Act allows higher education institutions to use additional supplemental funding to award emergency financial aid grants to graduate and undergraduate students experiencing "unexpected expenses and unmet financial need" as the result of the COVID-19 pandemic." The emergency financial aid grants are for expenses related to the disruption of campus operations due to the COVID-19 pandemic (including eligible expenses under a student's cost of attendance, such as food, housing, course materials, technology, health care, and childcare).

Section 277 of the COVID-relief Act (part of the Consolidated Appropriations Act) provides that a student does not include in gross income these emergency financial aid grants. In its Q &A on the subject the IRS Clarifies:

1. None of the emergency financial aid grants under the CARES Act for unexpected expenses, unmet financial need, or expenses related to the disruption of campus operations on account of the COVID-19 pandemic are includable in income. Expenses include unexpected expenses for food, housing, course materials, technology, health care, or childcare.

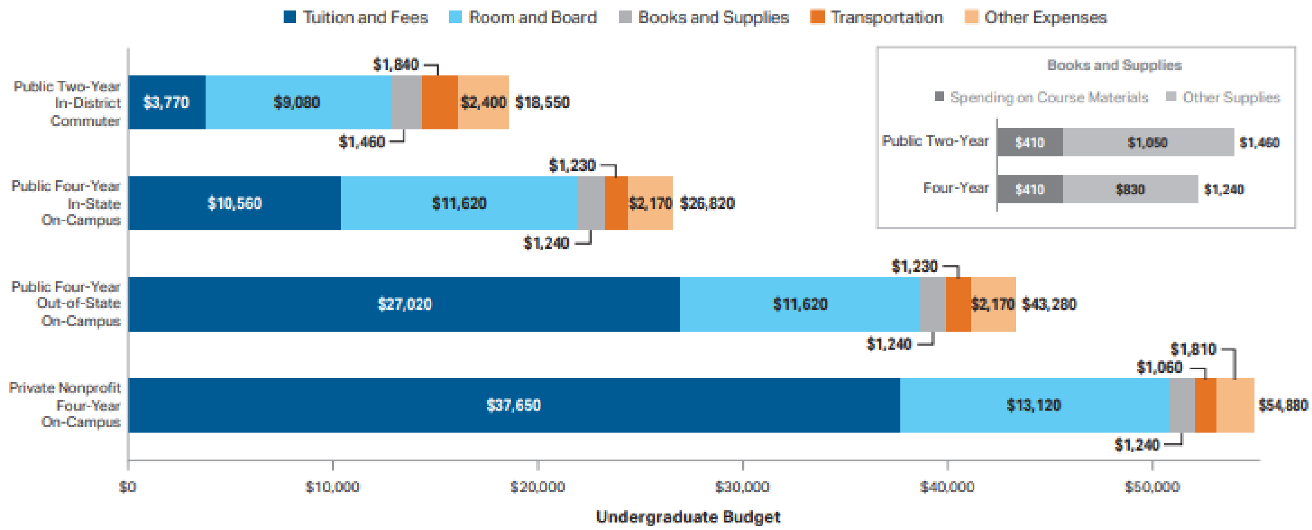
2. Payments made by a Federal agency, State, Indian tribe, institution of higher education, or scholarship-granting organization (including a tribal organization) because of an event related to the COVID-19 pandemic are not included in gross income.

3. Taxpayers that used the aid grant to purchase course-related books, supplies and equipment that are now online can claim the American Opportunity Credit, the Lifetime Learning Credit or the tuition and fees deduction for these expenses if they otherwise meet the requirements. Currently the tuition and fees deduction has expired and is not available for tax years beginning after December 31, 2020. Please note: You cannot claim a Lifetime Learning Credit or a tuition and fees deduction for the expenses that were not required to be purchased from the college or university.

4. Educational institutions are not required to report the grant on Form 1099-Misc. However, the emergency payments used for qualified tuition and related expenses (QTRE) in box 1 of Form 1098-T. The grants themselves do not have to be reported in Box 5 Grants on Form 1908-T.

RISING COST OF COLLEGE AND THE STUDENT LOAN DEBT CRISIS

FIGURE CP-1 Average Estimated Full-Time Undergraduate Budgets (Enrollment-Weighted) by Sector, 2020-21



NOTE: Expense categories are based on institutional budgets for students as reported in the College Board's Annual Survey of Colleges. Figures for tuition and fees and room and board mirror those reported in Table CP-1. Data for books and supplies, transportation, and other expenses are for 2019-20 and reflect the average amounts allotted in determining the total cost of attendance and do not necessarily reflect actual student expenditures. Books and supplies may include course materials such as hardcopy textbooks, online textbooks, textbook rentals, and other supplies such as a personal computer used for study.

SOURCE: College Board, Annual Survey of Colleges; NCES, IPEDS Fall 2018 Enrollment data; Student Watch and Student Monitor.

(Source: **https://research.collegeboard.org/trends/college-pricing/figures-tables/average-published-charges-2019-20-and-2020-21**)

Students and their families are asked to pay an ever-increasing price for college. The average published in-state tuition, fees, and room and board for a four-year public institution increased by 15% between 2010–2011 and 2020–2021. For the same period, four-year private institution costs increased by 17%.

Unlike their parents who went to school during times of publicly subsidized universities and grants, today's education is funded mostly by a combination of family contributions and loans. It has been widely reported that 69% of the Class of 2019 graduated with average debt of $29,900 in both private and federal loans. All totaled, 44.7 million borrowers owe collectively $1.71 trillion in student loan debt.

Student loan debt is now the second highest consumer debt only behind mortgage debt. Unfortunately, most students are ill informed as to the costs and benefits of education. This is especially true for those that enroll in the supposed flexible for-profit schools that are relatively high priced. A study by the Brookings Institute found the default rate for for-profit schools was twice that of cheaper public two-year schools. Unlike other forms of debt, student loans are almost never dischargeable in bankruptcy.

The fastest growing segment of the student loan debt are consumers aged 60 and older who have taken out loans for children and grandchildren. While there has been talk about forgiving student loans, as of publication of this manual, no action has been taken.

The best way to avoid student debt is to become an informed consumer and take wise steps in trying to reduce the cost of education. Suggestions for reducing college costs include:

1. **Dual Enrollment:** Earn college credits while still in high school. The more credits earned while in high school will reduce the total cost of college.

2. **Take Advance-Placement Exams:** Advanced placement AP Tests were designed by the College Board. They are administered at high schools and other off-site testing locations. The program offers 38 different tests. Scores for these tests are accepted for credit or advance placement at most colleges/universities.

3. **Start at a Community College:** Take advantage of community colleges where tuition is lower and can be transferred to other universities. Some states have “guaranteed admission agreements” that detail which universities and which credits can be transferred. This is also a great option for those who are uncertain about their career options.

4. **Start at the Top:** For careers that require advanced degrees it is often better to spend the money on the graduate degree or professional school rather than on the under-graduate institution. Entrance to these advanced degree programs often rely more on standardized tests such as the Graduate Management Admission Test (GMAT), Law School Admission Test (LSAT) or Medical College Admission Test (MCAT) than the undergraduate degree.

5. **Consider Financial Aid:** Federal government is still the best source of financial assistance and low interest loans based on financial need. Everyone should complete the Free Application for Federal Student Aid (FAFSA) to determine the loan which may be available to them.

6. **Choose a School Which Offers the Best Package:** It is not the gross price but the net price after grants and other incentives that count. A national college consultant remarked recently that most of his clients paid less net cost at private universities.

7. **Take More Credits than Required:** The faster the completion, the greater the savings.

8. **The Student Working Might Not Be the Answer:** Student earnings count in determining the expected family contribution. Rather than working in a low paying job, the student’s time would be better spent applying for grants and studying.

9. **Get Free Advice:** Take advantage of school guidance counselors.

10. **File for Financial Aid Early:** Many schools’ aid is provided on a first come, first served basis.

11. **Get Professional Help.** Hire a financial coach that specializes in college planning.

Effective with the 2017–2018 FAFSA, income submissions are based on the prior 2-years’ tax returns. For those planning to attend college for the 2020–2021 year, the financial aid will be based on the 2018 tax return.

PLANNING TIP: Most software packages now have a feature to load tax return data onto a FAFSA Worksheet for clients. The FAFSA Form can be completed online at **www.fafsa.ed.gov**. Helpful information can also be found at **https://studentaid.ed.gov**.

DEALING WITH STUDENT LOAN DEBT

The CARES Act provided relief on Department of Education Loans (ED) loans from 03/13/2020 through 09/30/2020. The Department of Education expanded this relief through at least September 30, 2021. On August 6, 2021, President Biden extended the relief for another four months so the relief now runs through January 2022. The ED Relief includes:

1. Pause all payments for student loans.

2. Set interest rates at 0%, this prevents interest from accruing during the administrative forbearance period.

3. Halt collection of federal student loan debt.

4. The forbearance period will count as if there had been a payment for programs such as the public service loan forgiveness.

> **OBSERVATION:** Many graduates, including Gen Z (those born after 1995), fail to take advantage of several of the student loan benefits programs available. Particularly troublesome is that low-income students typically graduate with much higher loan balances. Additional information for these borrowers, along with several helpful links, can be found at **www.cnbc.com/2020/06/19/gen-z-unaware-of-covid-19-student-loan-relief-programs-study-finds.html**.

5. Those who made payments during the forbearance period are eligible to ask for a refund of those payments.

6. Recertifications of Income for borrowers that are repaying loans based on Income-Driven Repayment (IDR) have also been delayed.

More information on the latest updates is available at **https://studentaid.gov/announcements-events/coronavirus**.

EXAMPLE: Loans Eligible and Ineligible for 0% Interest and Payment Suspension

Eligible	Ineligible
• Direct Loans (defaulted and non-defaulted)	• Non-defaulted FFEL Program loans not owned by ED
• FFEL[1] Program loans owned by ED (defaulted and non-defaulted)	• Federal Perkins Loans not owned by ED (defaulted and non-defaulted)
• Defaulted FFEL Program loans not owned by ED	• Non-defaulted HEAL[2] loans
• Federal Perkins Loans owned by ED (defaulted and non-defaulted)	• Private student Loans
• Defaulted HEAL loans	

Notes:

[1] FFEL: Federal Family Education Loan

[2] HEAL: Health Education Assistance Loan

Bankruptcy

Student loans are difficult to discharge in bankruptcy. There are three factors required to be satisfied for discharge of a student loan in bankruptcy:

1. You wouldn't be able to maintain a basic standard of living if you had to pay back your federal student loans.
2. You can prove that the hardship will last for a large percentage of your repayment period, and
3. You honestly tried to repay your federal student loans before this point. This includes attempting to pay the loans through a workable payment plan.

REFINANCING FEDERAL LOANS

There is some flexibility in repayment of federal student loans. These include extending the terms of payment, deferment of the payment and forbearances. Normally, these processes all start with contacting the current student loan processor.

Direct Consolidation Loan

Direct Consolidation Loan allows for the individual to combine multiple federal education loans into one loan. Private education loans are not eligible for consolidation but will be considered in some instances in determining the term of direct consolidated loans.

Income Driven Repayment Plans

These programs set the monthly student loan payment based on income and family size. Often, at the end of the term any remaining balances are forgiven. There are four plans under the program:

1. <u>Revised Pay as You Earn Repayment Plan (REPAYE):</u> The repayments are generally based off on 10% of discretionary income. Term is for 20 Years for undergraduate study. Term is 25 years if repaying graduate or professional study.
2. <u>Pay As your Earn Repayment Plan (PAYE):</u> PAYE plans are 10% of discretionary income but will never be more than the standard loan payment. Term is for 20 years.
3. <u>Income-Based Repayment Plan (IBR)</u>**:** IBRs are 10% of discretionary income with a term of 20 years for new borrowers on or after July 1, 2014.
4. <u>Income Contingent Repayment Plan (IRC):</u> The lesser of 20% of discretionary income or what would have been paid on a fixed payment over 12 years. Term is for 25 years.

A series of student loan calculators can be found at **https://studentloanhero.com/featured/complete-guide-income-driven-repayment-plans-federal-student-loans**. These tools can help calculate the true costs of the differing types of income-based programs available.

Besides the Income Driven Repayment plans, there is an Income Sensitive Repayment plan for low-income borrowers who have Federal Family Education Loan (FFEL) Program Loans. Under this plan, payments are adjusted based on the income of the taxpayer. More information can be found at **https://studentaid.ed.gov/sa/repay-loans**.

For more information on the income-based repayments, visit **https://studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven**.

A useful loan repayment reference can be found at **https://studentloanhero.com/featured/the-complete-list-of-student-loan-forgiveness-programs**.

> **OBSERVATION:** These plans are attractive because they reduce the required monthly payment, do not impact the borrower's credit score and ultimately can result in forgiveness of a substantial portion of the loan. A major downside is that at the end of the term the forgiveness is taxable as debt forgiveness income (for forgiveness before 12/31/25, Please see "New Student Loan Discharges"). This is troubling in negative amortization cases where the payments are not large enough to pay the accruing interest. Filing status can also impact the amount of the payment. Married taxpayers may want to analyze the impact of the filing status on the plan's eligibility and repayment amount.

REPAYE Plan

Under this plan, the servicer generally uses both the borrower's and the spouse's income regardless of filing status (joint or separate filing). However, when the borrower is separated from the spouse or is unable to access the spouse's income the eligibility and repayments can be calculated based solely on the borrower's income.

PAYE, IBR, and ICR Plans

Generally if the couple files separate returns the loan servicer will use on the borrower's monthly income in determining eligibility and loan repayments. If a joint return is filed, the servicer will use the joint income.

For more information see "Married Borrowers at **https://studentaid.gov/manage-loans/repayment/plans/income-driven/questions**

New Student Loan Discharges

Before the enactment of the American Rescue Plan Act of 2021 (ARPA), IRC Sec. 108 provided exceptions to the general rule requiring the inclusion of cancellation of indebtedness (COD) income from the discharge of student loans for—

1. discharges in exchange for a provision requiring certain work for a certain period by certain professionals (e.g., a doctor in a public hospital in a rural area), or

2. discharges on account of the death or total and permanent disability of a student.

The IRS also provided additional relief from COD resulting from certain student loan discharges (e.g., for certain taxpayers who had loans discharged under the Department of Education's Closed School process or the Defense to Repayment discharge process). [IRC Sec. 108(f)]

LAW CHANGE ALERT: ARPA excludes from gross income certain discharges of student loans after December 31, 2020, and before January 1, 2026. [IRC Sec. 108(f)(5), as amended by ARPA §9675(a)] The "student loan discharge" exclusion applies to these types of loans:

1. Loans provided expressly for post-secondary educational expenses if the loan was made, insured, or guaranteed by a federal, state, or local governmental entity or an eligible educational institution. [IRC Sec. 108(f)(5)(A), as amended by ARPA §9675(a)]

2. Private education loans. [IRC Sec. 108(f)(5)(B), as amended by ARPA §9675(a)]

3. Any loan made by any educational institution qualifying as a 50% charity (for purposes of the income tax charitable deduction) if the loan is made under an agreement with any governmental entity (described in item 1) or any private education lender that provided the loan to the educational organization, or under a program of the educational institution that is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or a tax-exempt charitable organization. [IRC Sec. 108(f)(5)(C), as amended by ARPA §9675(a)]

4. Any loan made by an educational organization qualifying as a 50% charity or by a tax-exempt organization to refinance a loan to an individual to assist the individual in attending any educational organization but only if the refinancing loan is under a program of the refinancing organization which is designed as described in item 3. [IRC Sec. 108(f)(5)(D), as amended by ARPA §9675(a)]

The discharge of a loan made by either an educational institution or a private education lender is not excluded under the above rules if the discharge is on account of services performed for either the organization or for the private education lender. [IRC Sec. 108(f)(5), as amended by ARPA §9675(a)]

The exclusion applies to a partial or a full discharge of a student loan.

These provisions apply to discharges of loans after December 31, 2020. [ARPA §9675(b)]

FEDERAL LOAN FORGIVENESS PROGRAMS

Public Service Loan Forgiveness (PSLF)

PSLF Program forgives the remaining balance on Direct Loans after the debtor has made 120 qualifying monthly payments while working full-time for a qualifying employer. The program is based solely on working for a qualifying employer rather than on the type of work performed. The following qualify as PSLF employers:

1. Government organizations at any level (federal, state, local, or tribal),

2. Not-for-profit organizations that are tax-exempt under IRC Sec. 501(c)(3),

3. Other types of not-for-profit organizations that are not tax-exempt under IRC Sec. 501(c)(3), if their primary purpose is to provide certain types of qualifying public services,

4. Serving as a full-time AmeriCorps or Peace Corps volunteer also counts as qualifying employment for the PSLF Program.

The Public Service Loan Forgiveness Calculator at **https://studentloanhero.com/calculators/public-service-loan-forgiveness-calculator**, can assist in the determination of the breakeven point of wages versus forgiveness.

> **CAUTION:** Not all loans qualify for the program. A qualifying loan is any non-defaulted loan received under William D Ford Federal Direct Loan (Direct Loan) Program. To be eligible the borrower must be an employee not a contractor or subcontractor. Qualifying payments have a timeliness requirement and must be paid no later than 15 days after the due date. For more information, visit https://studentaid.gov/manage-loans/forgiveness-cancellation/public-service.

Teachers Loan Forgiveness Program

Teachers who teach full-time for five complete and consecutive academic years in a low-income school or educational service agency and meet other qualifications may be eligible for forgiveness of up to $17,500 on Direct Subsidized and Unsubsidized Loans along with Subsidized and Unsubsidized Federal Stafford Loans. For more information on the requirements of the program, visit **https://studentaid.gov/manage-loans/forgiveness-cancellation/teacher**.

Federal Perkins Loan Cancellation Program

Cancellation of up to 100% of a Federal Perkins Loan for serving full-time in a public or nonprofit elementary or secondary school system as a—

1. teacher in a school serving students from low-income families.

2. special education teacher, including teachers of infants, toddlers, children, or youth with disabilities; or

3. teacher in the fields of mathematics, science, foreign languages, or bilingual education, or in any other field of expertise determined by a state education agency to have a shortage of qualified teachers in that state.

> **NOTE:** Eligibility for teacher Perkins cancellation is based on the duties presented in an official position description, not on the position title. To receive a cancellation, the teacher must be directly employed by the school system. There is no provision for canceling Federal Perkins Loans for teaching in postsecondary schools. For more information, visit **https://studentaid.gov/manage-loans/forgiveness-cancellation/perkins**.

> **PLANNING TIP:** Congress enacted these special rules to encourage students to go into such occupations as medicine, nursing, and teaching in rural and low-income areas. These programs qualify for the exclusion from debt forgiveness income. [IRC Sec. 108(f)(2)]. See Rev. Rul. 2008-34 for a discussion of the application of IRC Sec. 108(f)(1) to a law school's loan repayment assistance program

When an application for PSLF is denied, consider the Temporary Expanded Public Service Loan Forgiveness (TEPSLF) program. This program was part of the Consolidated Appropriations Act of 2018. This is a limited funding program which requires an email be sent to **TEPSLF@myfedloan.org** requesting consideration and indicating the following information:

- *Subject:* TEPSLF request
- *Message:* I request that ED reconsider my eligibility for public service loan forgiveness.
- *Name:* [Enter the same name under which you submitted your PSLF application]
- *Date of Birth:* [Enter your date of birth in MM/DD/YYYY format]
- *Closing:* Thank you.

Total and Permanent Disability TDP Discharge

Relieves the borrower from having to repay a William D. Ford Federal Direct Loan (Direct Loan) Program loan, a Federal Family Education Loan (FFEL) Program loan, and/or a Federal Perkins Loan or to complete a TEACH Grant service obligation. To qualify the borrower needs to have a certification from—

1. The U.S. Department of Veterans Affairs (VA)
2. the Social Security Administration (SSA)
3. a physician

NOTE: To qualify for the disability discharge the taxpayer must be unable to engage in any substantial gainful activity due to a physical or mental impairment that is expected to result in death, has lasted for a continuous period of at least 60 months or can be expected to last for a continuous period of at least 60 months. For more information on this program see https://studentaid.ed.gov/sa/repay-loans/forgiveness-cancellation/disability-discharge#show-disability.

Death Discharge

Federal student loans will be discharged due to the death of the borrower or of the student on whose behalf a PLUS loan was taken out. If a parent with a PLUS loan dies or if the student dies the parents plus loan will be discharged. For more information, visit **https://studentaid.gov/manage-loans/forgiveness-cancellation/death**.

Borrower Defense to Repayment

Borrowers may be eligible for forgiveness of the federal student loans used to attend a school that misled them or engaged in other misconduct in violation of certain laws.

The borrower may assert borrower defense by demonstrating that the school, through an act or omission, violated state law directly related to federal student loan or to the educational services for which the loan was provided.

Borrowers who are eligible may be able to have all or part of their outstanding federal student loan debt forgiven and may be reimbursed for amounts already paid on those loans. There is a special application for those who attended Corinthian Colleges, including Everest, Heald, and Wyoming Tech. On June 16, 2021, the Department of Education announced it will award 100% discharge of loans for 18,000 borrowers who attended ITT Technical Institute (ITT).

On July 9, 2021, the Department of Education announced it approved more than 1,800 borrower defense claims for individuals who attended:

1. Court Reporting Institute (CRI)
2. Marinello Schools of Beauty (Marinello), and
3. Westwood College (Westwood)

In Rev. Proc. 2020-11, the IRS expanded its debt discharge relief granting an exemption for qualifying discharges from filing Form 1099-C. Those debtors who have been relieved by the Dept. of Education eligible for these provisions are not to be issued Notice of Cancellation of Debt.

INCOME LEVELS COMPARISON FOR VARIOUS COLLEGE BENEFITS

2021 Married Filing Joint		
Education Benefit	**Phase-out Begins**	**Phase-out Ends**
Lifetime Learning Credit	$119,000	$139,000
Savings Bond Interest Exclusion	$124,800	$154,800
Student Loan Interest Deduction	$140,000	$170,000
Tuition and Fees Deduction – Reinstated	$130,000	$160,000
American Opportunity Tax Credit	$160,000	$180,000
Coverdell Education Savings Account	$190,000	$220,000
529 Plans	Unlimited	Unlimited
2021 Single		
Education Benefit	**Phase-out Begins**	**Phase-out Ends**
Lifetime Learning Credit	$59,000	$69,000
Savings Bond Interest Exclusion	$83,200	$98,200
Student Loan Interest Deduction	$70,000	$85,000
Tuition and Fees Deduction – Reinstated	$65,000	$80,000
American Opportunity Tax Credit	$80,000	$90,000
Coverdell Education Savings Account	$95,000	$110,00
529 Plans	Unlimited	Unlimited

COMMON PROVISIONS OF EDUCATION CREDITS AND DEDUCTIONS

To claim an education credit or deduction, the taxpayer (if married) must file a joint return. Qualified education expenses paid by the student can be claimed by the taxpayer who claims the student as a dependent under IRC Sec. 151 [Reg §1.25A-5(a)].

PLANNING TIP: If divorced, unless otherwise released, the dependency exemption and relating educational credits go to the custodial parent regardless of who pays the expenses. It is important to consider this during divorce proceedings when including each parent's eligibility to claim the education credits.

Modified adjusted gross income (MAGI) is AGI determined without regard to the exclusions from gross income for foreign earned income and foreign housing costs, and the income exclusion for residents of Guam, American Samoa, Northern Mariana Islands, and Puerto Rico [IRC Sec. 25A(d)(3)].

Generally, *qualified higher education expenses* (QHEE) include tuition and fees required for the enrollment or attendance of a student at an eligible educational institution. Such expenses do not include—

1. Expenses paid for any course involving sports, games, or hobbies unless such course is part of the individual's degree program.

2. Expenses such as student activity and health fees, insurance expenses, transportation costs, room and board, or other unrelated expenses, whether or not paid to the eligible educational institution.

The amount of qualified higher education expenses for purposes of the education credits/deductions must be out-of-pocket costs. Therefore, the otherwise qualified tuition and related expenses for the tax year are reduced by amounts allocable to the tax year paid for the benefit of the student [IRC Sec. 25A (g)(2)]. Amounts that will reduce QHEE are—

1. Qualified scholarships and grants excludable from gross income under IRC Sec. 117.

2. Employer-provided educational assistance excluded from income under IRC Sec. 127.

3. Veteran's educational assistance allowance.

4. Educational assistance allowance for members of the Selected Reserve.

5. Any other educational assistance that is excludable from gross income (other than tax-free gifts and inheritances).

NOTE: See the earlier discussion on Emergency Student Grants for the impact of COVID related grants.

The deduction cannot be claimed for expenses that were paid with tax-free withdrawals from Education Savings Accounts, tax-free withdrawals from 529 Plans, or excluded interest from Education Savings Bonds.

A taxpayer may not take more than one credit/deduction for the same student in the same tax year. A taxpayer claiming more than one child as a dependent can still end up with more than one credit or deduction.

EXAMPLE: Claiming more than one child as a dependent.

Dave and Pat have two children at Miami University. One is a college freshman, and one is a senior. Each paid $10,000 in tuition while attending school fulltime. Their MAGI is under $114,000. Their maximum credit is $5,000 (both qualify for the AOTC of $2,500 each).

Variation: The older child is only a part-time student taking less than half the required credits for full-time status. The tax credit would be $4,500. The younger child qualifies for the AOTC and the older child would qualify for a $2,000 Lifetime Learning Credit ($10,000 × 20%).

Prepayments of QHEE during one tax year for academic periods that begin during the first three months of the following tax year are included in the credit/deduction calculation for the year they are paid [Reg. §1.25A-3(e)]. The Tax Court in *Angela A. Terrell v. Comm.* (TC Memo 2016-85) affirmed this treatment in finding for the taxpayer.

EXAMPLE: Prepayments of qualified higher education expense

In December 2020, Tim pays tuition and fees at Iowa State for the winter semester, beginning January 2021. For purposes of the education credits/deductions, he is eligible to claim the credit/deduction in 2020 (cash basis) for the 2021 academic year.

COMMON PROVISIONS OF AOTC AND LIFETIME LEARNING CREDIT

An eligible educational institution for purposes of the education credit is defined by reference to §481 of the Higher Education Act of 1965:

1. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions, and some vocational schools.

2. The institution must offer credit toward an associate degree, a bachelor degree, or another recognized postsecondary education credential.

3. The institution must be eligible to participate in Department of Education student aid programs [IRC Sec. 25A (f)(2)].

Form 8863 is used to claim the Lifetime Learning Credit and AOTC. Part III must be completed for each student.

PLANNING TIP: A permanent record should be maintained to track the number years the AOTC credits have been claimed.

PRACTICE TIP: IRS Pub. 970 has flowcharts that will help determine if the taxpayer can claim the Lifetime Learning Credit or AOTC. The Interactive Tax Assistant on the IRS website is also helpful (www.irs.gov/help/ita/am-i-eligible-to-claim-an-education-credit).

AMERICAN OPPORTUNITY TAX CREDIT (IRC SEC. 25A)

The maximum American Opportunity Tax Credit (AOTC) is $2,500 per student, per year; 40% of the credit is refundable. It is calculated as follows:

1. 100% of the first $2,000 of qualified higher education expenses plus
2. 25% of the next $2,000 of qualified higher education expenses.

The maximum qualified higher education expenses are $4,000 with no inflation adjustment.

The credit phases out based on MAGI. The phase-out amounts may be adjusted annually for inflation. Currently, the filing status MAGI phase-outs for 2021 are—

1. MFJ and Surviving Spouse: $160,000–$180,000
2. Single and Head of Household: $80,000–$90,000

The credit offsets the alternative minimum tax (AMT). Forty percent of the credit is refundable. To claim the refundable portion, a taxpayer must be self-supporting and eligible to claim themselves.

Eligible expenses also include course materials related to enrollment for postsecondary (college) undergraduate education expenses up to four years.

An *eligible student* for purposes of the AOTC is one who meets the following requirements:

1. The student is an individual who is enrolled for at least one academic period in a degree, certificate, or other program leading to a recognized educational credential.
2. The student is at least a half-time student, meaning the student carries at least half the normal fulltime workload (as determined by the institution) for the student's course of study [IRC Sec. 25A (b)(3)(B)]. The student only needs to meet the half-time requirement for one academic period during the year, and the tuition for all other periods during the year when this requirement is not met still counts as an eligible expense for credit purposes [Reg §1.25A-3(d)(ii)].

EXAMPLE: Student eligibility

Laurie attends Florida State, which has a 12-hour fulltime curriculum per semester. Laurie needs to carry a six-hour load at least one semester (5 months) to claim the AOTC.

3. As of the beginning of the taxable year, the student has not completed the first four years of post-secondary education at an eligible educational institution [IRC Sec. 25A (b)(2)(c)]. Whether a student has completed the first four years of postsecondary education depends on whether the particular institution awards the student four years of academic credit prior to the beginning of the

tax year [Reg §1.25A-3(d)(iii)]. Only actual class credit is counted in determining the student's year-of-study status [Reg §1.25A-3(d)(2), Example 4].

EXAMPLE: Student has not completed a post-secondary education within four years

Larry attended Skidmore College from 2016 to 2020 but has not graduated. Neither he nor his parents have claimed the AOTC four times for Larry. In 2021, he is at least a half-time student, but is still a junior based on his credits. He can claim the AOTC for 2020, as he is still an undergraduate student.

The AOTC is not allowed for any academic period if the student has been convicted of a federal or state felony consisting of the possession or sale of illegal drugs for an offense that occurred while they were receiving federal financial aid. FAFSA has developed a special worksheet to determine eligibility [Reg §1.25A-3(d)(iv)].

A taxpayer may claim the credit for each eligible student, which includes the taxpayer, the taxpayer's spouse, or an individual eligible to be claimed as a dependent.

If the student *does not* qualify as a dependent under IRC Sec. 151, and could claim themselves, the student can claim the refundable and nonrefundable portion of the AOTC. If the student *does* qualify as a dependent under IRC Sec. 151, the parents can waive the right to claim the student. The student can then claim only the nonrefundable portion of the credit.

It does not matter that the student actually qualifies as the parent's dependent, nor does it matter who actually paid the tuition [Reg §1.25A-1(g)(2), Example 2 and FSA 200236001]. The credit can only reduce the dependent's tax liability. The refundable portion of the credit cannot be utilized by the student [IRC Sec. 25A (i)(6), as amended].

The PATH Act of 2015 expanded the IRS's math error authority for the disallowance of improper credits. IRS can disallow credits it deems inappropriate requiring the taxpayer to prove that the IRS is incorrect.

The PATH Act also applied the tax preparer negligence penalties to the AOTC. (Reg §1.6695-2T) Failure to exercise due diligence is subject to a $545 penalty for returns filed in 2021. (See Chapter 13 for further discussion of the due diligence penalty.)

PLANNING TIP: A *taxpayer identification number* (TIN) is a Social Security number, an individual taxpayer identification number (ITIN) or an adoption taxpayer identification number (ATIN). The TIN must be issued for both the student and the taxpayer prior to the due date for filing the tax return, thus preventing the taxpayer from retroactively claiming the AOTC by amending or late filing a return in which the student or the taxpayer did not have a TIN [IRC Sec(s). 25A(g)(1)(B)(i) and (B)(ii); Prop. Reg §1.25A-1(e)(2)(i)].

PLANNING TIP: If parents are unable to take advantage of the education credits, they should consider allowing the child to take the credit.

EXAMPLE: Allowing child to claim the AOTC

Ken and Sally elect not to claim their daughter, Linda as a dependent even though they are eligible to do so. Under Reg §1.25A-1(f), Linda is now eligible to claim the AOTC on her federal income tax return, and Ken and Sally are not allowed to claim any education credit.

Assume that Ken and Sally have $180,000 wages, $30,000 in mortgage interest, $20,000 in charitable contributions, and no other dependents. Linda has $6,000 of ordinary income from interest and $13,000 of long-term capital gain from the sale of stock. The family paid at least $4,000 of tuition that is eligible for the AOTC. The following reflects the difference between Ken and Sally's claiming Linda as a dependent on the parental return or declining to claim her as a dependent.

	Claiming the Dependent		**Declining Dependent Claim**	
	Ken & Sally	**Linda**	**Ken & Sally**	**Linda**
Wage income	$ 180,000	$ —	$ 180,000	$ —
Interest income	—	6,000	—	6,000
Long-term capital gain	—	13,000	—	13,000
Adjusted gross income	$ 180,000	$ 19,000	$ 180,000	$ 19,000
Charitable contributions	(20,000)	—	(20,000)	—
Mortgage interest	(30,000)	—	(30,000)	—
Standard deduction	—	(1,100)	—	(1,100)
Taxable income	$ 130,000	$ 17,900	$ 130,000	$ 17,900
Tax liability	$ 20,180	$ 2,891	$ 20,180	$ 2,891
Credit for other dependents	(500)	—	—	—
American Opportunity Tax Credit	—	—	—	(2,500)
Net tax liability	$ 19,680	$ 2,891	$ 20,180	$ 391

LIFETIME LEARNING CREDIT (IRC SEC. 25A)

The Lifetime Learning Credit covers tuition and fees for qualified individuals to acquire or improve job skills, and is available for undergraduate, graduate, or professional courses [Reg §1.25A-4(c)].

A taxpayer may claim the credit for the combined expenses paid by the taxpayer for all eligible students, which include the taxpayer, taxpayer's spouse, and individuals qualified as dependents. The credit can be claimed in multiple years.

The maximum nonrefundable credit is $2,000 for each eligible taxpayer per year. It is calculated as follows:

1. Qualifying tuition and fees up to $10,000 multiplied by a 20% credit.
2. The credit is not adjusted for inflation, but the MAGI phase-out is.

In contrast to the AOTC, there are no restrictions as to the number of times the credit can be taken. It can be taken for a degree or non-degree program and the taxpayer need not be a fulltime student. Convicted felons are also eligible for the credit.

This credit phases out based on modified AGI. The phase-out amounts may be adjusted annually for inflation. Currently, the filing status AGI phase-outs for 2021 are—

1. MFJ and Surviving Spouse: $119,000–$139,000

2. Single and HOH: $59,000–$69,000

FORM 1098-T REPORTING

Taxpayers must have received a Form 1098-T from the college or university they attended before filing for the AOTC or the Lifetime Learning Credit. The Consolidated Appropriations Act of 2016 eliminated the option for colleges and universities to report the aggregate amount billed for qualified tuition and related expenses (Box 2 on Form 1098-T). Institutions required to file Form 1098-T are to report amounts using a cash basis in Box 1 on Form 1098-T.

ELECTION TO ALLOCATE SCHOLARSHIPS AND GRANTS AS TAXABLE INCOME (IRC SEC. 117)

A student who has paid out of pocket for higher education expenses may benefit by making an election to allocate an otherwise excludable scholarship or grant as a taxable room and board expense reimbursement.

The requirements of IRC Sec. 25A indicate that to the extent a scholarship or grant is excludable from income under IRC Sec. 117 it will reduce the amount of QTRE (qualified tuition and related expenses) paid and therefore reduce any potential American Opportunity Credit.

Many taxpayers are unaware they have the right to apply many grants and scholarships against living expenses. It should be noted that not all awards are eligible for this election.

While this creates taxable income, it also increases the amount of tuition and fees that are available to take the AOTC.

The failure to make the election to allocate a portion of an otherwise excludable scholarship or grant to taxable income as allowed by IRC 117(b)(2) affects an estimated 9-10 million students annually.

The elected income is not subject to SE tax.

NOTE: One of the continuing questions has been whether the elected income under IRC Sec. 117 is *earned* or *unearned* income. The renewed debate was fueled in part by the change in the tax rates for children under the TCJA (these tax rates have since been repealed by the SECURES Act—see Chapter 3). There is some conflicting guidance that should be considered when advising your client:

1. Technical Advice Memorandum 9525004, published on 06/23/1995, indicated that when the scholarship payment is compensatory in nature, it is earned income (i.e., possibly eligible for the standard deduction).

2. Publication 970, page 6, states, “If you file Form 1040, include the taxable amount in the total on Line 1. If the taxable amount was not reported on Form W-2, also enter ‘SCH’ and the taxable amount on the dotted line next to line 1.”

3. Rev. Rule 77-263 lead to a decision by the National Labor Relations Act that football players who were receiving grant-in-aid scholarships to play football at Northwestern University might be employees. IRC Sec. 117(a) excludes qualified scholarships for degree candidates. **www.taxhistory.org/www/features.nsf/Articles/0473CF3877C2DB9C85257E1B004D63C5?OpenDocument**.

The election is made by recognizing the otherwise excludable scholarship or grant as income on the student's return (no attached statement is required).

IRC Sec. 117(b)(2) indicates a qualified scholarship or grant may be applied to living expenses to the extent allowed by the terms of the scholarship or grant. The student is not bound by the allocation made by the educational institution. If the scholarship or grant is restricted to QTRE then the student may not make an election to apply the award to non-QTRE.

EXAMPLE: Tax treatment of scholarships

Bob is a full-time student and a dependent of his parents. During the year Bob has $2,500 in wages and receives $18,000 in scholarships and Pell Grants that the school uses to completely offset his tuition and fees (QTRE). If Bob accepts the allocation of the scholarships and grants against the QTRE, he will have not tax liability, but his parents will not receive the AOTC. If Bob chooses to treat $4,000 of the allowable grants as used against living expenses, he will have a tax liability of $365 but the parents would be eligible for the full AOTC of $2,500. Note: The income recognized from the scholarships/grants is unearned income for the purpose of the kiddie tax calculation.

PLANNING TIP: The key to this planning technique is that the grant or scholarship must be able to be used for living expenses. The election is made by reporting the grant or scholarship as taxable income on the recipient's tax return(student). This allows the parents of the child to claim the AOTC. For more information see treasury's fact sheet available at www.treasury.gov/resource-center/tax-policy/Documents/Report-Pell-AOTC-Interaction-2014.pdf.

STUDENT LOAN INTEREST DEDUCTION (IRC SEC. 221)

An individual may deduct interest paid on any qualified education loan above-the-line on Form 1040. The maximum amount a taxpayer is permitted to deduct, regardless of the number of students in the family, is $2,500 and is not indexed to inflation [IRC Sec. 221(b)(1)].

The interest deduction is ratably phased out for individuals with the following 2021 MAGI [IRC Sec. 221(b)(2)]:

1. MFJ and Surviving Spouse: $140,000–$170,000

2. Single and Head of Household: $70,000–$85,000

MAGI is AGI without the deduction for education loan interest and exclusions for (1) foreign earned income and housing costs, and (2) income from certain U.S. possessions and Puerto Rico [IRC Sec. 221(b)(2)(C)].

CAUTION: The deduction *is not* available for MFS returns or individuals who qualify as dependents of another taxpayer [IRC Sec. 221(e)(2)].

Only the individual who is legally required to make interest payments under the loan terms may claim the deduction. The deduction is not allowed to an individual who qualifies as a dependent of another taxpayer for that year [Reg §1.221-1(b)(2)(ii)].

PLANNING TIP: Frequently the parents and the student will both be required to sign the loan as obligors. During the period of attendance, the parent will make the payments and claim the interest deduction. After graduation and obtaining employment, the child may assume the loan and start making the payments (and presumably taking the deduction). Check the Form 1098-E to ensure the child's SSN was used. Contact the lending institution to change the SSN and other information as needed.

EXAMPLE: Tax treatment of student loan interest paid by a dependent

Bob pays $1,200 of qualified education loan interest that he has the legal obligation to repay from the University of New Hampshire. Bob's parents are entitled to treat Bob as a dependent. Bob is not entitled to a deduction on the interest he paid because he is a dependent. His parents are not entitled to a deduction because they have no legal obligation to repay (Reg §1.221-1(b)(2)(ii), Ex. 2).

PLANNING TIP: Parental income often exceeds the AGI limits. In many cases, a recent college graduate's income will not. Taxpayers should consider taking out the loans in the student's name to ensure a deduction. Further, a negative impact on the parent's credit could occur if the loan is in their name and the student gets behind on payments. Refinancing post-graduation is another option. This can be the best of all worlds, relieving the parents but allowing them in the early years to take the deduction. Then allowing the child to take the deduction in the early years of employment when their income may be low enough to qualify for the deduction.

HIGHER EDUCATION EXPENSE DEDUCTION (HEED) (IRC SEC. 222)

As a result of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, the HEED was retroactively reinstated as of 01/01/2018–12/31/2020. As of August 6, 2021, this provision has not been extended.

For purposes of the HEED, the Qualified Tuition & Related Expenses (QTRE) are identical to the AOTC and LLC. There is no requirement to complete any particular period of study to obtain the deduction. Those expenses refunded may not be deducted. These expenses are deductions to AGI.

The phase-out for the HEED is a cliff. Prior to the lower range of the threshold, the deduction will be $4,000. During the phase-out, the deduction will be $2,000. When the taxpayer reaches the upper end of the threshold, the deduction will be zero.

The HEED is subject to the following 2020 AGI phase-out ranges (this range is not subject to inflation adjustments):

1. MFJ and Surviving Spouse: $130,000–$160,000

2. Single and Head of Household: $65,000–$80,000

EDUCATION SAVINGS BONDS (IRC SEC. 135)

An individual who redeems qualified U.S. Savings bonds may exclude the interest from the redemption proceeds from income up to the amount of qualified higher education expenses (QHEEs).

The Savings bond exclusion is one of the oldest mechanisms to save for college. Unfortunately, the exclusion is subject to a relatively low phase out that was not substantially adjusted until the PATH Act. The 2021 AGI phase-out ranges are—

1. MFJ and Surviving Spouse: $124,800–$154,800

2. Single and Head of Household: $83,200–$98,200

CAUTION: The exclusion is not available for MFS returns [IRC Sec. 135(d)(3)].

Qualified U.S. Savings Bonds are defined as being—

1. U.S. Savings Bonds issued at a discount after December 31, 1989,

2. For a taxpayer who was at least 24 years old before the bond's issue date, and

3. Registered either in the name of the taxpayer or in the names of the taxpayer and spouse (i.e., not in the name of a dependent child).

QHEEs include—

1. Tuition, fees, and contributions to 529 Plans and Coverdell Education Savings Accounts [IRC Sec. 135(c)(2)] (e.g., room, board, books, supplies, etc., are not included in qualified higher education expenses).

2. Expenses for taxpayer, taxpayer's spouse, or taxpayer's dependent.

3. Eligible educational institutions such as a public or nonprofit university, college, or vocational school eligible for federal funding.

QHEEs must be reduced by Hope Credit, Lifetime Learning Credit, QTP payments or reimbursements, Coverdell Education Savings Accounts payments, scholarships and fellowships, veteran benefits, and other tax-exempt educational benefits.

Bond proceeds (principal plus interest) exceeding QHEE reduce the interest exclusion [IRC Sec. 135(b)(1)A).

EXAMPLE: Calculating bond interest exclusion when a portion of proceeds are used for QHEEs

If 50% of the total proceeds are used to pay for tuition after the reduction for the education credits, education savings accounts withdrawals, scholarships, VA benefits, and QTP payments or reimbursements, then 50% of the interest portion is excludable.

PLANNING TIP: Often taxpayers who have saved for years find that they are over the AGI threshold when the funds are needed. Consider advising clients about the ability to move the funds into 529 plans and Coverdell Education Savings Accounts before their AGI is beyond the threshold.

Election to exclude interest must be made in the year of bond redemption on Form 8815.

Form 8818 is used to record redemption of qualified U.S. Savings bonds and to compute the interest portion when the bonds are redeemed and is for the taxpayer's use and not filed with the parents' or child's tax return.

COVERDELL EDUCATION SAVINGS ACCOUNTS (CESA) (IRC SEC. 530)

The Coverdell Education Savings Account (CESA), formerly known as the Education IRA, is maintained to pay qualified education expenses of the designated beneficiary.

Taxpayers can contribute up to $2,000 per child to these plans, and tax-free distributions can be taken for qualified expenses for not only postsecondary education expenses, but also expenses at public, private, or religious elementary and secondary education schools (i.e., K–12 education expenses). There is no deduction for these contributions.

Beneficiaries must be under age 18 at the time of the contribution, with no age limit for students with special needs as defined by regulations—which have yet to be issued.

The definition of *qualifying expenses* is broad and includes:

1. Tuition, fees, and academic tutoring,
2. Special needs service in the case of a special needs' beneficiary,
3. Books, supplies, and other equipment (includes computers used by the student and family),
4. Room and board (if at least half-time),
5. Uniforms and transportation costs, and
6. Supplementary items and services, including extended-day programs.

In the case of contributors who are individuals, the $2,000 contribution phases out ratably for contributors with 2021 MAGI as follows [IRC Sec. 530(c)(1)]:

1. MFJ and Surviving Spouse: $190,000–$220,000
2. Single, Head of Household, and MFS: $95,000–$110,000

Annual contributions in excess of $2,000 are subject to a 6% tax that is annually imposed on the beneficiary [IRC Sec. 4973(e)]. The penalty tax will not apply if any excess contributions, and related earnings, are withdrawn by June 1st of the following year [IRC Sec. 4973(e)(2)(A) and IRC Sec. 530(d)(4)(C)].

Contributions are allowed to a CESA and a 529 Plan for the same beneficiary.

NOTE: Beneficiaries of CESAs should receive Form 5498 (IRA Contribution Information) showing the amount contributed during the year on their behalf. If the total of the amounts shown on all the beneficiaries' Forms 5498 exceed $2,000, an excess contribution has occurred, and corrective action should be taken.

Distributions from a CESA are income tax-free up to qualified higher education expenses [IRC Sec. 530(d)(2)(A)], regardless of whether the designated beneficiaries are enrolled fulltime, half-time, or less than half-time at an eligible educational institution (Notice 97-60).

EXAMPLE: Determining tax treatment of CESA distribution

Richard has contributed $6,000 over the years to the CESA of his daughter, Rosie. Rosie is ready to attend Texas A&M and the account has a total balance of $10,000, representing total earnings of $4,000. Richard withdraws $2,000 from the account, but he only incurs $1,600 of qualified higher education expenses.

The withdrawal consists of $1,200 of contributions [(total contributions of $6,000 ÷ $10,000 total balance) × $2,000] and $800 of earnings. There is a $400 excess distribution ($2,000 withdrawn less $1,600 of qualified expenses). The taxable amount is the amount of the excess attributable to earnings, which in this case is $160 [$400 excess distribution × ($800 earnings ÷ $2,000 distribution)]. Richard must include the $160 in income and pay a 10% penalty on that amount.

The AOTC (Hope) and Lifetime Learning Credits may be claimed in the same year as exclusions from income are taken for distribution from CESAs on behalf of the same student. The CESA distribution must not be used to pay for the same educational expenses for which a credit is claimed.

OBSERVATION: CESA can be used for expenditures other than tuition and fees on which the tax credits are based.

NOTE: In the previous example, if Rosie was a half-time (or more) student for at least one school term and the parent(s) has qualifying AGI, they would be eligible for the AOTC, which far exceeds the value of the exclusion. The AOTC would equal $1,600. However, if the CESA distribution was used for room and board expenses and other funds were used for tuition, the taxpayer can benefit from both.

If the balance in a CESA account is not used by the time the beneficiary reaches age 30, then any remaining amounts must be distributed within 30 days after the beneficiary reaches age 30. Any earnings included in the distribution are subject to income tax and a 10% penalty. The penalty can be avoided by having the CESA rolled over to another family member under age 30 within 60 days of distribution.

Rollover

Unused Coverdell funds can be rolled over into another Coverdell account within 60 days for the benefit of the same beneficiary or a member of the beneficiary's family who has not attained age 30. [IRC 530(d)(5)]. Member of the family includes the designated beneficiary's spouse and the following other relatives:

1. son, daughter, stepchild, foster child, adopted child, or a descendant of any of them,

2. brother, sister, stepbrother, or stepsister,
3. father or mother or ancestor of either,
4. stepfather or stepmother,
5. son or daughter of a brother or sister,
6. brother or sister of father or mother,
7. son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law,
8. the spouse of any individual listed above, and
9. first cousin.

PLANNING TIP: For financial aid purposes, parent owned CESAs are treated as a parent's asset, and child owned CESAs are not included. Additionally, distributions will not be treated as a student's income.

Military

An individual who has received a military death gratuity and/or Servicemembers' Group Life Insurance (SGLI) can contribute the amounts received to one or more Coverdell educational savings accounts without regard to the annual limitation and phaseout limits. [Joint Comm Staff, Tech Expln of the Hearos Earnings Assistance and Relief Tax Act of 2008(JCX-44-08), 05/20/3008, p20: Notice 2010-15]

QUALIFIED TUITION PROGRAMS (QTP) (IRC SEC. 529)

A 529 plan is a tax-advantage savings plan designed to encourage saving for future education, the plans are legally known as *qualified tuition plans* (QTPs) are sponsored by states, state agencies or educational institutions.

There are two types of QTPs: prepaid tuition programs and educational savings plans. All 50 states and the District of Columbia sponsor at least one type of 529 plan. In addition, a group of private colleges and universities sponsor a prepaid tuition plan.

Prepaid tuition plans allow the saver to purchase units or credits at participating colleges and universities for future tuition in today's dollars.

Educational savings plans are investment accounts that often include mutual fund and exchange-traded funds. The portfolios may be static fund portfolios and age-based or target-date portfolios. For tax years beginning after December 31, 2014, account owners or designated beneficiaries are allowed to change the investment strategy twice a year [IRC. 529(b)(4)].

Each state sets many of its own rules, such as residency requirements and plan limits. A current state-by-state comparison is available at **www.savingforcollege.com**.

Qualified Education Expenses (QEEs) include:

1. Tuition and related fees, books, supplies, technology, and equipment required for the enrollment or attendance of a designated beneficiary.

2. If the beneficiary is enrolled at least half time with reasonable room and board.

3. For elementary school and secondary school tuition, the amount of cash distributions from all 529 plans cannot exceed $10,000 for elementary and secondary school tuition per student incurred during the year.

PLANNING TIP: The SECURES Act added some additional QEEs. Fees, books, supplies, and equipment required for the designated beneficiary's participation in an apprenticeship program. The program must be registered and certified with the Secretary of Labor.

In addition, the Act allows tax-free distributions from 529 plans to pay principal or interest on a qualified education loan of the designated beneficiary or a sibling of the designated beneficiary. This allows a student loan distribution to be made from a 529 plan account to a sibling of the account's designated beneficiary without changing the designated beneficiary. Any interest amounts paid by a qualified withdrawal under this provision of a 529 plan are not deductible as student loan interest.

Contributions

Anyone can contribute to a plan for a given beneficiary. There are no AGI limitations imposed on the contributor or the beneficiary.

The 529 Plan creates estate planning opportunities and financial aid, especially for grandparents as they maintain control of the assets and how and when it is distributed. They can also change the beneficiary and yet it is treated as a completed gift eligible for the $15,000 annual gift exclusion for 2021. For greater wealth transfer opportunities, a special election is available by filing gift tax returns and electing to take the contribution ratably over five years.

1. Parent and student owned 529 plans are included as parental assets when applying for financial aid.

2. If the grandparents are the owners, then the value of the plan is excluded and will not affect financial aid eligibility.

3. Most states require the naming of a contingent beneficiary, this is an important part of the planning process.

EXAMPLE: 529 Plan estate planning opportunities

Memaw gifted $75,000 to a QTP for her new granddaughter, Happy. Memaw filed Form 709, checking Box B on Schedule A, and elected to take the five-year-averaging election, allowing funds to earn tax-deferred income sooner and not lose any of Memaw's unified credit for estate tax purposes.

Variation 1: Memaw now has five grandchildren and transfers $75,000 ($15,000 × 5 years) to each of her five grandchildren's 529 plan accounts, totaling $375,000. She still controls it, decides how to invest it and can move it to different beneficiaries.

Variation 2: Memaw's next-door neighbors have a new baby. Memaw sets up a 529 Plan of $1,000 as a present. She is permitted to do this even though she is not related. Memaw may be able to deduct the present at the state level depending on her state or residence.

Distributions from 529 Plans are excluded from the income of the beneficiary and the contributor if used for qualified education expenses. However, *nonqualified* withdrawals distributed to the account owner or beneficiary are taxed to the contributor and penalized at the same 10% federal additional tax that currently applies to nonqualified withdrawals from CESAs.

Penalties are avoided if the withdrawals are made on account of the designated beneficiary's death or disability or are made on account of a tax-free scholarship, other educational assistance allowance or payment received by the designated beneficiary or entrance into a US service academy.

Tax on earnings and the penalty are avoided if withdrawals are rolled over to qualified beneficiaries QTPs. Any amount withdrawn from a QTP and rolled over within 60 days to a QTP for the same beneficiary or for a new designated beneficiary who is a member of the family of the old beneficiary is not treated as taxable distribution. Similarly, the designated beneficiary can be changed without triggering taxable income provided the new beneficiary is a member of the family of the old beneficiary [IRC Sec. 529(c)(3)(C)]. *Family member* is defined in the same manner as for ESA rollovers [IRC Sec(s). 529(e)(2) and 530(d)(5)].

OBSERVATION: Members of the beneficiary's family for these purposes include the beneficiary's spouse, children and their descendants, stepchildren and their descendants, brothers and sisters (including stepbrothers and stepsisters) and their children, parents and their siblings, grandparents, stepparents, certain in-laws, spouses of all the foregoing, and first cousins [IRC Sec. 529(e)(2)]. This is the same definition used for Coverdale Savings Accounts.

Distributions that are not used for education are not included as income if rolled over within 60 days. This rollover can be to a 529 Plan of an existing member or a new beneficiary who is a member of the old beneficiary's family [IRC Sec. 529(e)(2)]. (See IRS Pub. 970 for a complete list.)

TCJA IMPACT: The TCJA provides that a distribution from a 529 account is tax-free if it is transferred within 60 days of distribution to an ABLE account of the designated beneficiary or their family. The rollover may not exceed the maximum contribution amount allowed for the ABLE account. ($15,000 for 2021 and 2020). The distribution must occur from December 23, 2017 through December 31, 2025 [IRC Sec. 529(c)(3)(C)(i)(III)].

The funds distributed by grandparents to grandchildren from the 529 Plan do show up as untaxed income to the grandchild in the year received for financial aid purposes.

When the beneficiary of a QTP receives a refund of amounts withdrawn that were QHEEs, the owner of the QTP has 60 days to roll the funds back into the QTP. The ability to complete such a rollover was initially authorized by the PATH Act. In Notice 2018-58 and Notice 2020-23 the IRS further clarified the ability to make such a qualified rollover within 60 days.

Delaying Reimbursements

The real power of the 529 Plan is its tax-free growth potential. Unfortunately, most American's contributions are not large enough to make a meaningful dent in the cost of a four-year college education. A question often asked is "What if I just let the funds grow indefinitely and reimburse myself for the expenses in later years when the funds have grown significantly?"

In Announcement 2008-17, the IRS acknowledged that IRC Sec. 529 is silent regarding whether distributions must be made from the account in the same year as QHEEs were made. The IRS states that it intends to issue proposed regulations to limit reimbursement of QHEEs to the year the payment is made and up to March 31st of the following year. At present, a long delay in reimbursement may be considered abusive by the IRS. In IRC 529(f), Congress gave the IRS the authority to both issue regulations and prevent abuse. Most practitioners are advising reimbursing the expenses in the year of payment.

ACHIEVING A BETTER LIFE EXPERIENCE (ABLE) ACCOUNTS

The Achieving a Better Life Experience (ABLE) Act of 2014 was enacted on December 19, 2014, as part of the Tax Increase Prevention Act of 2014 for tax years beginning in 2015. This created a savings plan for disability much like a college savings plan.

The Act permits states to establish and maintain a new type of tax advantaged savings program for disabled (includes blind) individuals.

LAW CHANGE ALERT: The IRS has published Prop. Reg §128246-18, Contribution Limits Applicable to ABLE Accounts. The proposed regulations incorporate without change the guidance provided in Notice 2018-62. Additionally, they have incorporated changes necessary to incorporate the statutory modifications of TCJA.

1. Additional contributions
2. Poverty Line
3. Return of Excess Contributions

Most states have ABLE account programs in place. A resource and comparison tool for different state plans can be found at **www.ablenrc.org**.

The beneficiary will remain eligible for government benefits, such as SSI and Medicaid. Qualifying beneficiaries must be—

1. Disabled as defined in IRC Sec. 529A(e)(1), and
2. The beneficiary must have documentation of disability that indicates onset before age 26, although he can have a fund at any age, and
3. A disability certification is required.

The account is used for the purpose of meeting the qualified disability expenses, such as education, housing, transportation, employment training and support, assistive technology, personal support services, health care expenses, financial management, and administrative services such as legal fees, expenses for oversight and monitoring, funeral and burial expenses of the designated beneficiary.

Contributions are not tax deductible for federal purposes, but many states do have deductions similar to educational accounts. They can be found using the comparison tool at **www.ablenrc.org**.

Annual contributions are limited to the individual gifting limit ($15,000 for 2021 and 2020). After the annual gift limit is reached ($15,000), the designated beneficiary of the ABLE account may contribute an additional amount, up to the lesser of the beneficiary's compensation for the year or the federal poverty line for a one-person household. Contributions must occur from December 23, 2017 through December 31, 2025.

EXAMPLE: Additional ABLE account contributions from a beneficiary

Allie is disabled and the beneficiary of an ABLE account in which her parents contributed $15,000 for 2021. Allie works and earns $14,000 in Florida. Allie can make an additional contribution of $12,880 [the lesser of what she earned $14,000 or the federal poverty line for a one-person household ($12,140)].

An overall limitation will be the same as that set for 529 college plans under IRC Sec. 529(b)(6). However, ABLE benefits in excess of $100,000 would be subject to the SSI individual resource limit.

CAUTION: SSI benefits are lost when personal assets (including retirement) exceed $2,000. Any balance over $100,000 in an ABLE account is considered an asset and will cause a suspension of benefits. When the balance drops below $100,000, SSI, SNAP and Medicaid benefits will resume (the individual does not become ineligible).

Form 5498-QA will be used to report contributions.

Other issues associated with the accounts include—

1. Excess contributions are subject to a 6% excise tax on the excess contribution. They can be returned to the contributor on a LIFO (last in first out) basis.

2. Funds can be transferred to other eligible individuals on a program-to-program basis or by rollover.

3. Withdrawals not used for qualifying disability expenses are subject to a 10% penalty on the earnings.

See Chapter 6 for savers credit available for a beneficiary making additional contributions as indicated in Item H.

Medical Assistance (Medicaid) Payback

Under federal law, if a beneficiary receives Medical Assistance (Medicaid), the state that provided the Medical Assistance (Medicaid) is permitted to file a claim seeking repayment from the ABLE account in an amount up to the amount of Medical Assistance (Medicaid) provided during the time the beneficiary had an ABLE account. However, each state sets its own limits.

For instance, in Pennsylvania, the agency responsible for administering Medical Assistance *may not* file a claim against a Pennsylvania ABLE account but *can* seek redress once the funds from the ABLE are transferred to the estate (within limits).

CARES ACT PROVIDES HELP FOR STUDENTS

The CARES Act (the Act) has added eligible student loan payments to amounts allowed as tax free fringe benefits under IRC Sec. 127(c)(1)(B). Payments made under an educational assistance plan are not includable in the employee's income up to $5,250 for payments made after March 27, 2020 and before January 1, 2021. The Consolidated Appropriations Act of 2021 (CAA) extends the exclusion for loan repayment through 2025 [IRC Sec. 127(c)(1)(B), as amended by the CAA]

1. These amounts are solely for the benefit of the employee.
2. Qualified student loan interest paid by this benefit is not deductible by the employee.

These payments are subject to the overall $5,250 per employee limit for all educational payments. Eligible student loan repayments are payments by the employer, whether paid to the employee or a lender, of principle or interest on any qualified higher education loan as defined in IRC Sec. 221(d)(1) for the education of the employee (but not of a spouse or dependent). [IRC Sec. 127(c)(1)(B)].

WHERE TO GO FOR MORE INFORMATION

Government resources:

- **www.fafsa.gov** – Fill out the FAFSA or FAFSA renewal online (new direct site)
- **https://studentaid.ed.gov/sa/fafsa/estimate** – Estimate financial aid
- IRS Pub. 970, Tax Benefits for Education

Other College/529 Plan/Scholarship Information:

- **www.savingforcollege.com** – Comprehensive information about 529 Plans
- **www.collegesavings.org** – College Savings Plan Network; general information about saving for college
- **www.collegeboard.org** – Comprehensive sites for financial aid calculators, college searches, and other financial aid info
- **www.fastweb.com** – Free, searchable scholarship database that locates sources of financial aid suitable to the student (Top 10 Admission Tips)
- **www.unigo.com/scholarships#/fromscholarshipexperts** – Scholarship searches

ABLE Act:

1. Notice 2015-18 and Notice 2015-891
2. ABLE Resource center **www.ablenrc.org**

APPENDIX 6A: COMPARISON OF EDUCATIONAL EXPENDITURE TAX INCENTIVES (2021)

Attribute **IRC Sec.**	**American Opportunity Tax Credit** 25A	**Lifetime Learning Credit** 25A	**Withdrawal From Traditional and Roth IRAs** 72(t)	**Educational Assistance Program** 127	**Savings Bond Interest Exclusion** 135	**Student Loan Interest Deduction** 221	**Qualified Tuition Programs (QTPs)** 529	**Education Savings Account (ESA)** 530
Tax Benefit	Up to 40% may be refundable. Remainder nonrefundable.	Nonrefundable tax credit.	No 10% early withdrawal penalty.	Employer-paid benefits are excludible from income.	Interest is excludable from income.	Above-the-line deduction.	Tax-free withdrawals (savings plan) or tax-free education credits (prepaid plan).	Tax-free withdrawals
2021 Annual Limits	Credit up to $2,500 per student (100% of first $2,000 and 25% of next $2,000)	Credit up to $2,000 per return (20% of up to $10,000 of expenses)	Amount of qualifying expenses.	Exclude up to $5,250 of benefits.	Amount of qualifying expenses.	Deduction of up to $2,500.	Nondeductible contributions limited to amount QTP determines is necessary to cover qualified expenses.	$2,000 nondeductible contribution per child under age 18 and any age special-needs child.
Qualified Education Expenses[a]	Tuition, fees, and course materials	Tuition and fees; books[b]	Tuition and fees; books, supplies and equipment; room and board if at least half-time attendance.	Tuition and fees; books, supplies and equipment.	Tuition and fees; contributions to QTPs and ESAs	Tuition and fees; books, supplies and equipment, room and board, transportation, other necessary expenses.	Tuition and fees; books, supplies and equipment; computer and technology; room and board if at least half-time attendance, including expenses for participation in a registered apprenticeship program. Principle or interest payments on qualified education loans (up to a cumulative $10,000).[c]	Tuition and fees; books, supplies and equipment; room and board if at least half-time attendance; payments to QTP; computer used by student and family.
Qualifying Education	First four years of postsecondary education.	All undergraduate and graduate levels.	All undergraduate and graduate levels.	All undergraduate and graduate levels.	All undergraduate and graduate levels.	All undergraduate and graduate levels.	Elementary, secondary, undergraduate and graduate levels.	Elementary, secondary, undergraduate and graduate levels.
Other Rules and Requirements	Can be claimed beginning after 2009; must be enrolled at least half-time in a degree program; parents can shift credit to student by not claiming as a dependent. No felony drug conviction(s).	Available for unlimited number of years for both degree and nondegree programs; parents can shift credit to student by not claiming as a dependent.	Qualifying expenses include those of a grandchild; withdrawals from Roth IRAs are always tax and penalty-free to the extent of contributions.	Cannot also claim an education credit for employer-paid expenses.	Applies only to qualified Series EE bonds issued after 1989 or Series I bonds; bond owner must be at least 24 years old when bond issued.	Must be enrolled at least half-time in a degree program; loan must be incurred solely to pay qualified education expenses.	Account owner retains control over beneficiary designation and can reclaim funds; can elect to spread gift over five years; some states allow state deduction to residents.	Contributions must be made by the original return due date; may also contribute to QTP; mandatory distributions at age 30.

Attribute	American Opportunity Tax Credit	Lifetime Learning Credit	Withdrawal From Traditional and Roth IRAs	Educational Assistance Program	Savings Bond Interest Exclusion	Student Loan Interest Deduction	Qualified Tuition Programs (QTPs)	Education Savings Account (ESA)
IRC Sec.	25A	25A	72(t)	127	135	221	529	530
2021 Modified AGI Phase-Out								
MFJ	$160,000–$180,000	$160,000–$180,000	N/A	N/A	$124,800–$154,800	$140,000–$170,000	N/A	$190,000–$220,000
All Others	$80,000–$90,000	$80,000–$90,000			$83,200–$98,200	$70,000–$85,000		$95,000–$110,000
MFS	Do Not Qualify	Do Not Qualify			Do Not Qualify	Do Not Qualify		$95,000–$110,000

Notes:

a Qualifying educational expenses must be reduced by any tax-free scholarships and grants. The same educational expenses cannot be used for figuring more than one benefit.

b Books, supplies and equipment if the cost must be paid to the eligible educational institution as a condition of the enrollment or attendance of the student at the institution.

c The deduction for student loan interest is not available for any Section 529 distributions used to pay such interest.

CHAPTER 7: ITEMIZED DEDUCTIONS

Learning Objective

Completion of this chapter will enable participants to—

- Determine the impact of the recent law changes to medical expenses, taxes, charitable contributions, qualified residence interest, and miscellaneous itemized deductions.
- Maximize interest deductions through an understanding of the interest tracing rules.
- Advise clients on charitable contribution issues including issues with conservation easements

WHAT'S NEW

1. The Taxpayer Certainty and Disaster Tax Relief Act of 2020, which was part of the Consolidated Appropriations Act (CAA) of 2021, made the 7.5% AGI limit for medical expenses deductions permanent.
2. The IRS released proposed reliance regulations on state and local tax (SALT) limitation workarounds.
3. Heightened scrutiny on conservation easements.
4. The CARES Act provided individuals with a $300 above-the-line deduction for cash contributions made, generally, to public charities in 2020. The CAA extended and enhanced this deduction through 2021. This is discussed further in Chapter 41- Adjustments to Income.
5. The CARES Act increased the modified adjusted gross income threshold for cash contributions to public charities to 100% for 2020. The CAA extended this treatment into 2021. [IRC 170(b)(1)(G)(i) as amended by CAA Sec. 213].
6. For contributions of food inventory made in 2020, the deduction limitation increases from 15% to 25% of the net aggregate income from all businesses from which the contributions were made. As this manual went to press, the provision had not been extended.
7. The CARES Act allows high deductible health plans to pay for expenses for tele-health and other remote services without regard to the deductible amount for the plan.
8. The CARES Act added nonprescription and menstrual products as allowable expenses for Health Savings Accounts and Archer Medical Savings Accounts to be treated as paid for medical care. (See Chapter 41 for further information.)
9. The qualified mortgage insurance premium deduction was set to expire at the end of 2020. The CAA extended the deduction through 2021.

STANDARD VERSUS ITEMIZED DEDUCTIONS

Form 1040, Schedule A, will still be used to calculate itemized deductions. The taxpayer can use the greater of allowable itemized deductions or the standard deduction.

NOTE: Individuals who do not itemize are allowed a $300 above the line deduction for 2020 and 2021 contributions to public charities. See Chapter 41 for more information.

Standard Deductions

The standard deductions for 2021 and 2020 are as follows:

Filing Status	**2021**	**2020**
Single and MFS	$12,550	$12,400
Head of Household	$18,800	$18,650
MFJ and QW	$25,100	$24,800
Dependent of another	$1,100[a]	$1,100[a]
Additional Deduction. Elderly/Blind-Married or Qualifying Widow(er)	$1,350	$1,300
Additional Deduction. Elderly/Blind-Unmarried	$1,700	$1,650

Note:

[a] For individuals claimed as a dependent by another taxpayer, the standard deduction is the greater of $1,100 or the amount of earned income plus $350 up to the single standard deduction.

MEDICAL AND DENTAL EXPENSES

The TCJA provided a two-year reduced limit of 7.5% medical floor for the years 2017 and 2018. The Taxpayer Certainty and Disaster Tax Relief Act of 2019 extended the 7.5% for years beginning after December 31, 2018, and before January 1, 2021 (i.e., tax years 2019 and 2020). The CAA made the 7.5% limit permanent.

Medical and dental expenses include costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body. These expenses include payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes.

Many states now have laws for the use of medical marijuana (spelled “marihuana” in Michigan statutes). However, federally the drug is still considered a controlled substance. Per IRS Pub. 502—

> You can't include in medical expenses amounts you pay for controlled substances (such as marijuana, laetrile, etc.) that aren't legal under federal law, even if such substances are legalized by state law.

In IRS Ann. 2021-7, the IRS notified taxpayers that expenses incurred for personal protective equipment (PPE) to mitigate the spread of COVID-19 are qualifying medical expenses both for the medical deduction and for reimbursement under FSAs, HRAs, and HSAs.

NEW PROPOSED REGULATIONS: In June 2020, the IRS issued proposed REG-109755-19, which would allow payments to direct primary care arrangements and healthcare sharing ministries to be treated as medical expenses (these payments are not considered medical insurance). A "direct primary care arrangement" would be a contract between an individual and one or more primary care physicians under which the physician or physicians agree to provide medical care (as defined in IRC Sec. 213(d)(1)(A)) for a fixed annual or periodic fee without billing a third party [Prop. Reg. §1.213-1(e)(1)(v)(A)].

COURT CASE: In 2011, a taxpayer and his same-sex partner took a medical expense deduction for in vitro fertilization costs. The IRS disallowed the claimed deduction and the district court agreed with the IRS that the IVF costs were not deductible medical expenses under IRC Sec. 213 because they were not incurred for medical care of the taxpayer, his spouse, or a dependent. Furthermore, they were not for the diagnosis, cure, mitigation, treatment, prevention of disease, nor to affect any bodily structure or function of the taxpayer. The court said that it was not deductible regardless of sex, sexual orientation, or gender [*Morrissey v. U.S.*, 119 AFTR 2d 2017-401].

PLR 202114001: A legally married male couple sought a ruling that would allow them to deduct, as medical expenses, fees and costs related to their having a baby. Only medical costs directly attributable to the couple are deductible. The IRS concluded that the couple could deduct, as medical expenses, only fees and costs directly attributable to their own medical care, such as sperm donation and freezing. According to the ruling, deductible medical expenses include only costs and fees directly attributable to medical care for diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body of the taxpayer, the taxpayer's spouse, or taxpayer's dependent. Since expenses involving egg donation, IVF, and gestational surrogacy are incurred for someone who isn't the taxpayer, the taxpayer's spouse, or the taxpayer's dependent, payments related to those services are not deductible as medical expenses under IRC Sec. 213.

Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. They do not include expenses that are merely beneficial to general health, such as vitamins or a vacation.

COURT CASE: A taxpayer pursued integrative medical care, a form of alternative medicine. The IRS disallowed the deduction, claiming the treatments were not routinely or universally recognized. The Tax Court held for the taxpayer, determining the expenses were for healing services under Reg. §1.213-1(e)(1)(ii). The Tax Court focused on the taxpayer's sincere belief in the treatments and that they weren't of a type that would be pursued for nonmedical reasons. This is a bench opinion that cannot be relied upon for precedent. [*Victoria Malev*, Docket No. 1282-16S (Tax Ct.)]

Medical expenses include premiums paid for insurance covering the expenses of medical care, and amounts paid for transportation (including automobile expenses at the greater of out-of-pocket expenses for gas and oil, or $ .16 per mile for 2021(down from $ .17 per mile in 2020 and $ .20 per mile for 2019) to get medical care. Medical expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract.

NOTE: An extensive list of Qualified Medical Expenses is available at www.irs.gov in IRS Pub. 502, Medical and Dental Expenses.

PLANNING TIP: Although education is not normally viewed as medical care, specialized schooling for a dependent child because of a medical condition may be deductible as a medical expense if a physician recommends special education to correct a medical condition [Reg. §1.213-1(e)(1)(v)(A)]. The IRS has privately ruled that children diagnosed with severe dyslexia requiring special education constitutes medical care under IRC Sec. 213 [PLR. 200521003].

OBSERVATION: Any special school expenses that qualify as deductible medical costs may also be eligible for reimbursement under Section 125 cafeteria or other healthcare reimbursement plans.

Eligible Individuals

A taxpayer's medical expenses include expenses paid for a person who meets the IRC Sec. 152 definition of a *dependent*. IRC Sec. 213(a) expands the definition to also include—

1. A dependent child who filed a joint return with a spouse,
2. A relative who would have qualified except for exceeding the income level, or
3. Anyone who would have qualified as the taxpayer's dependent but was claimed as a dependent on another person's return. Accordingly, divorced or separated parents can deduct medical expenses paid for a child regardless of which parent claims the dependent or who is the custodial parent, if the two parents together provide more than half of the child's support. [IRC Sec. 213(d)(5); Rev. Proc. 2008-48]
4. Medical expenses paid for a dependent claimed under a multiple support agreement are also deductible [Reg. §1.213-1(a)(3)].
5. A spouse or former spouse, if the marriage existed either when the expenses were incurred or when the bills were paid.

EXAMPLE: Determining Dependent Status for Medical Expense Purposes

Liam, age 22, receives more than half of his support from his parents. During the year, he earned more than the exemption amount and is no longer a student. The parents cannot claim Liam as a dependent because he is not a qualifying child since he is over 18 and not a full-time student, nor is he a qualifying relative since his income exceeds the exemption amount. The parents if they itemize can claim deductions for Liam's medical expenses since under IRC Sec. 213(a), the gross income test is ignored for the "qualifying relative" definition. Therefore, Liam is a dependent for medical purposes but not for other tax benefits.

Medical expenses are deductible only by the taxpayer who actually pays them. Thus, taxpayers claiming medical expenses must pay the expense directly to the medical provider rather than the dependent. Furthermore, large medical bills for parents or persons other than dependent minor children should be paid directly to the medical service providers (e.g., doctors, hospitals, etc.) to avoid taxable gifts (Ltr. Rul. 9023030). Amounts paid directly to medical service providers are not taxable transfers (i.e., gifts) [IRC Sec. 2503(e)].

A taxpayer can include in medical expenses amounts paid for special equipment installed in a home, or for improvements, if their main purpose is medical care for the taxpayer, spouse, or any dependent [Reg. §1.213-1(e)(1)(iii)]:

1. The deductible medical expense of a permanent improvement that increases the value of a taxpayer's property is the difference between its cost and the increase in the value of the property.

PLANNING TIP: Appraisals of a property both before and after the improvement are needed to substantiate the amount of the increase in a property's FMV.

2. If the value of a taxpayer's property is not increased by the improvement, the entire cost is a medical expense.

3. Certain improvements made to a home to accommodate a taxpayer's disabled condition, or that of his spouse or any dependents who live in the home, do not usually increase the home's value and are included in full as medical expenses (e.g., constructing exit ramps or widening doorways). Additional costs incurred during the improvements for architectural or aesthetic reasons are not medical expenses.

4. If a capital expenditure for the home qualifies as a medical expense, its operating costs and upkeep also qualify as medical expenses as long as the medical requirement continues.

EXAMPLE: Treatment of Medical Expense that Results in Home Value Increase

John and Mickey install a central air conditioner with a special filtration system in their home as prescribed by their physician for their child's allergies. The system costs $6,200 and increases the value of the home by $1,000. They are entitled to a deduction of $5,200, the difference of the $6,200 cost of the air conditioning system and the $1,000 increase in the value of the home.

Certain taxpayers who pay premiums for qualified health insurance coverage may be eligible for the Health Coverage Tax Credit (HCTC). See Chapter 13, Personal and Business Credits.

A taxpayer can include in medical expenses insurance premiums paid for policies covering medical care [IRC Sec. 213(d)(1)(D)]. Medical care policies can provide payment for treatment that includes:

1. Hospitalization, surgical services, X-rays,

2. Prescription drugs and insulin,

3. Dental care,

4. Replacement of lost or damaged contact lenses, and

5. Long-term care (see the following).

PLANNING TIP: All Medicare premiums (B, C, D, and supplemental plans) are deductible medical expenses. Do not include premiums or medical and dental expenses paid by the employer unless the premiums are included in Box 1 of the taxpayer's Form W-2.

Premiums paid before a taxpayer reaches age 65 for insurance for medical care for himself, his spouse, or his dependents after he reaches age 65 are medical care expenses in the year paid if they are payable in equal yearly installments or more often. This prohibits a multi-year lump sum from being deducted when paid.

A taxpayer cannot include premiums paid for—

1. Life insurance policies,

2. Policies providing payment for loss of earnings,

3. Policies for loss of life, limb, sight, etc.,

4. Policies that pay a guaranteed amount each week for a stated number of weeks if a taxpayer is hospitalized for sickness or injury,

5. The part of car insurance that provides medical insurance coverage for all persons injured in or by a taxpayer's car, or

6. Health or long-term care insurance if the taxpayer elected to pay these premiums with tax-free distributions from a retirement plan made directly to the insurance provider and these distributions would otherwise have been included in income.

To the extent the cost of premiums paid for qualified long-term care insurance contracts qualify as medical services, they too are deductible as a medical expense.

A qualified long-term care insurance contract is an insurance contract that provides only coverage of qualified long-term care services. The contract must—

1. Be guaranteed renewable,

2. Not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed,

3. Provide that refunds (other than refunds on the death of the insured, complete surrender or cancellation of the contract, and dividends under the contract) must be used only to reduce future premiums or increase future benefits, and

4. Generally, not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer, or the contract makes per diem or other periodic payments without regard to expenses.

NOTE: Qualifying long-term care expenses include necessary diagnostic and preventive care as well as therapy, rehabilitation, and treatment. They also include maintenance and personal care services for chronically ill individuals if the services are prescribed by a licensed health care practitioner.

The age limitations on deductible long-term care insurance premiums are per individual, not per return [IRC Sec. 213(d)(10)]:

2021 Long-Term Care Premiums

Age	Deduction Limit
40 or under	$450
41–50	$850
51–60	$1,690
61–70	$4,520
71 or over	$5,650

PLANNING TIP: A taxpayer can include in medical expenses medical care allocations of "Continuing Care Retirement Community" (CCRC) fees paid either monthly or as a lump sum under an agreement with a retirement home. A taxpayer may use the percentage method rather than the IRS's more complicated actuarial method. The agreement must require payment of a specific fee as a condition for the home's promise to provide lifetime care including medical care. Taxpayers can use a statement from the retirement home to prove the amount properly allocable to medical care [*Baker v. Comm.*, 122 TC 143 (2004)].

SENIOR AND LONG-TERM CARE ISSUES

Many healthy seniors are electing to live in "senior communities" that provide a carefree lifestyle along with a continuum of care in the event or illness or personal decline. Most senior living or retirement communities require a substantial one-time fee to be paid in exchange for a promise to provide lifetime living accommodations and care that includes medical care.

Rev. Rul. 76-481 states that to the extent the retirement community can document a reasonable estimate of the percentage of its overall operating expenses spent for providing medical care, that percentage can be applied to the one-time and continuing payments to the facility.

In *Finzer*, a federal District Court denied an amended return based on a refund claim for the deduction of a portion of a one-time entrance fee as a medical expense based on the fact that 90% (minimum) of the fee was refundable to the taxpayers or their estate. (*Finzer, Jr. v. U.S.*, 100 AFTR 2007-5340)

The Tax Court supported using a percentage to determine the amount of monthly service fees allocable to medical care when the IRS attempted to force the taxpayer to use an actuarial method yielding a lesser amount (*Delbert L. Baker, et ux. v. Comm.*, 122 TC 143).

The amount of operating expenses allocated to the facility's cost of providing medical care to the taxpayer, spouse, or dependent qualifies as a medical expense in the year paid, even though medical services will be provided in future years. However, current deductions of payments for future medical care (extending substantially beyond the close of the tax year) generally are not allowed unless the future care is purchased in connection with obtaining lifetime care (Rev. Rul. 93-72).

The tax treatment is different in the case of a chronically ill individual under a prescribed care plan who pays the entrance fee since the fee may be deductible as qualified long-term care.

Medical expenses include amounts paid for qualified long-term care [IRC 213(d)(1)]. Such services are defined as being necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services (as well as maintenance or personal care services) that are required by a chronically ill individual and are provided pursuant to a plan of care prescribed by a licensed health care practitioner [IRC Sec. 7702B(c)(1)].

A *licensed health care practitioner* is a physician, registered professional nurse, licensed social worker, or other individual who meets requirements specified by the IRS [IRC Sec. 7702B(c)(4)].

A *chronically ill individual* is one who has been certified by a licensed health care practitioner within the last 12 months as [IRC Sec. 7702B(c)(2)]—

1. Being unable to perform at least two activities of daily living (eating, toileting, transferring, bathing, dressing, and continence) without substantial assistance for at least 90 days due to a loss of functional capacity,

2. Having a similar level of disability (as determined under regulations to be prescribed by the IRS), or

3. Requiring substantial supervision to protect against safety or health threats caused by the individual's severe cognitive impairment.

Notice 97-31 provides guidance on the first and third definitions of when a taxpayer is chronically ill. It refers to these as the activities of daily living (ADL) trigger and the cognitive impairment trigger, respectively.

The ADL trigger hinges on substantial assistance from another individual. Notice 97-31 defines substantial assistance as:

1. Hands-on assistance, meaning the physical assistance of another person is required for the individual to perform ADLs, or

2. Standby assistance, meaning another person's presence within arm's reach of the individual is necessary to prevent injury while the individual is performing ADLs (for example, being ready to catch the individual in the event of a fall during bathing or dressing, or to prevent choking while eating).

Notice 97-31 also clarifies that the 90-day requirement does not establish a waiting period before which expenses are deductible as long-term care expenses. Rather, a licensed health care practitioner must certify that the individual is expected to be unable to perform two or more ADLs for at least 90 days due to a loss of functional capacity.

Notice 97-31 also defines two key terms of the cognitive impairment trigger: the *substantial supervision* required to protect the individual's health and safety, and the *severe cognitive impairment* causing the need for supervision.

Substantial supervision means continual supervision that is necessary to protect the individual from threats to his or her safety, such as may result from wandering. Such supervision can include cuing by verbal prompting, gestures, or other demonstrations.

Severe cognitive impairment means a loss or deterioration in intellectual capacity that is comparable to Alzheimer's disease and similar forms of irreversible dementia, which is measured by clinical evidence and standardized tests that reliably measure impairment in the individual's (1) short-or long-term memory; (2) orientation to people, places, or time; and (3) deductive or abstract reasoning.

The deductibility of amounts paid to living facilities is based on the needs of the individual and the services provided by the institution not on the whether the individual receives, or the institution is qualified to provide medical care. Meeting the Notice 97-31 requirements allows amounts paid to nursing homes as well as other long-term care institutions to qualify as medical expenses.

EXAMPLE: Treatment of Nursing Home Expenses

Ricky Bobby, age 68, has made arrangements to enter into the Happy Dale Retirement Community. For Happy Dale's promise to provide him with living accommodations, meals, activities, and life-time care, including medical care, he pays an entrance fee of $90,000 and will pay a monthly fee of $4,500. Happy Dale provides Ricky Bobby a statement that 35% of its expenses are related to the provision of medical care to residents. Accordingly, he is entitled to claim 35% of the entrance fee as well as 35% of the monthly fees in the year paid.

Variation: Same facts, except that Ricky Bobby suffers from dementia and an established medical professional certifies the need for long-term care. The entire entrance fee of $90,000 along with 100% of the monthly fees paid during the year are deductible.

OBSERVATION: Often the deductions associated with nursing home and assisted living facilities exceed the taxpayer's AGI. Consideration should be given to accelerating income to take advantage of these otherwise lost deductions.

STATE AND LOCAL TAXES (SALT) UPDATE

One of the more controversial TCJA provisions was the SALT limitation for tax years beginning after December 31, 2017, and before January 1, 2026. This change was particularly reviled in states with high income and property taxes.

While the law did not affect taxes related to trades and businesses, it limited the taxes deducted on Schedule A to an aggregate amount for any taxable year to $10,000 ($5,000 in the case of a married taxpayer filing a separate return). Taxes included in this limit include [IRC 164(b)(6)]—

1. State and local real estate taxes
2. State and local personal property taxes
3. State and local, and foreign, income, war profits and excess profits taxes

The definition of *state and local* includes taxes imposed by a U.S. possession and taxes levied by Native American tribes.

The law additionally eliminated the deduction for foreign real property taxes. As with prior law, the taxpayer is given the choice of deducting either state sales taxes or state and local income taxes.

The law did not change the treatment of foreign income taxes. Generally, a taxpayer can take either a deduction or a credit for income taxes imposed on him by a foreign country or a U.S. possession. However, a taxpayer cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. Generally, the dollar-for-dollar credit is more valuable than the deduction.

PLANNING TIP: Certain states require employees to make mandatory contributions to state funds providing disability or unemployment benefits. The most common (not all-inclusive) are Alaska Unemployment Compensation Fund, California Disability Benefit Fund, New Jersey Nonoccupational Disability Benefit Fund and Unemployment Compensation Fund, New York Disability Benefit Fund, Pennsylvania Unemployment Compensation Fund, Rhode Island Temporary Disability Benefit Fund, Washington State Supplement Workmen's Compensation Fund. In the 2020 Pub. 17, page 94 indicated that these taxes were to be treated as Line 5a State and Local Taxes.

As a workaround to the SALT limit, some states instituted credit programs that allowed the taxpayer to make a charitable contribution to a Section 170(c) organization that would provide a state-level tax credit to offset the taxpayer's state or local liability.

On August 11, 2021, the IRS issued final Regulations on SALT limitation workarounds which retained the application of the *quid pro quo* principle under IRC Sec. 170. The final Regulations amend the rules in Reg. §1.170A-1(h) which address a donor's payments in exchange for consideration. Specifically, the final Regulations revise Reg §1.170A-1(h)(4) to provide definitions of *in consideration for* and *goods and services* for purposes of applying the rules in Reg. §1.170A-1(h). Under the final Regulations, a taxpayer will be treated as receiving goods and services in consideration for a taxpayer's payment or transfer to an entity described in IRC Sec. 170(c) if, at the time the taxpayer makes the payment or transfer, the taxpayer receives or expects to receive goods or services in return. [Reg §1.170A-1(h)(4)(i)] The final Regulations also provide similar rules under IRC Sec. 642(c) for payments made by a trust or decedent's estate. (TD 9864).

Part of the IRS's basis in the Regulations is the U.S. Supreme Court's decision in the American Bar Endowment case, which held that a charitable contribution must be a transfer of money or property without adequate consideration. [*American Bar Endowment* (S Ct 1986) 58 AFTR 2d 86-5190].

Potentially, this treatment could deny a charitable deduction for a taxpayer who has SALT deductions below the $10,000/$5,000 limit. Notice 2019-12 also announced that the IRS intends to issue proposed Regulations amending Reg. §1.164-3 to provide a safe harbor for certain individuals who make a payment to, or for the use of, an entity described in IRC Sec. 170(c) in return for a SALT credit.

Under this safe harbor, an individual who itemizes deductions, and who makes a payment to a Section 170(c) entity in return for a SALT credit, would be able to treat the credit as a payment of SALT as the credits are applied to the taxpayer's state tax liability.

Any credits that were not allowed against the state liability would carry over and be treated as a payment of SALT when applied in the later year.

In Notice 2020-75, the IRS announced that it will issue proposed Regulations to clarify that state and local taxes imposed on and paid by a flow-through entity may be deductible by the entity and not subject to the SALT limitation. **OBSERVATION:** The safe harbor only restores the taxpayer to the position they would have been in had they not made the SALT credit contribution. In a memorandum of law filed on July 1, 2020, in State of New Jersey et al v. Mnuchin, New Jersey, New York, and Connecticut argued that the IRS's position on the credits is contrary to historic treatment of SALT incentives.

EXAMPLE: Treatment of State Income Tax Credit

In year 1, Abe makes a payment of $500 to a state/local agency and in return receives a dollar-for-dollar state income tax credit. Prior to application of the credit, Abe's state income tax liability for year 1 was $500 or more. Abe applies the $500 credit to his year 1 state income tax liability. Under section 3 of this notice, Abe treats the $500 payment as a payment of state income tax in year 1 for purposes of section 164.

EXAMPLE: Treatment of Multi-Year State Income Tax Credit

In year 1, Taxpayer Bob makes a payment of $7,000 to a state/local entity and in return he receives a dollar-for-dollar state income tax credit, which under state law may be carried forward for three taxable years. Prior to application of the credit, Bob's state income tax liability for year 1 was $5,000. Bob applies $5,000 of the $7,000 credit to Bob's year 1 state income tax liability. Bob treats $5,000 of the $7,000 payment as a payment of state income tax in year 1 for purposes of IRC Sec. 164. Prior to application of the remaining credit, Bob's state income tax liability for year 2 exceeds $2,000. Bob applies the excess credit of $2,000 to his year 2 state income tax liability. For year 2, B treats the $2,000 as a payment of state income tax for purposes of IRC Sec. 164.

General Deductibility Rules

General rules:

1. The tax must be imposed on the taxpayer (see the discussion on beneficial or equitable ownership under mortgage interest, below).
2. Generally, a taxpayer can deduct property taxes only as an owner of a property. If a spouse owns the property and pays real estate taxes, the taxes are deductible on the spouse’s separate or joint return.
3. If a taxpayer is a cash basis taxpayer, only taxes actually paid during the tax year can be deducted.

State and Local Income Taxes

State and local income taxes are deductible. Such deductions may include:

1. Withheld state and local income taxes in the year they are withheld (e.g., Form W-2, Form 1099-R).
2. Estimated tax payments made during a year to a state or local government. However, a taxpayer must have a reasonable basis for making estimated tax payments. Any estimated state or local tax payment not made in good faith at the time of payment is not deductible.
3. Any part of a refund of prior-year state or local income taxes that a taxpayer credits to estimated state or local income taxes.
4. Mandatory contributions to state benefit funds withheld from wages are deductible.

General Sales Taxes

A taxpayer may elect to deduct state and local general sales taxes, instead of state and local income taxes, as an itemized deduction [IRC Sec. 164(b)(5)]. Taxpayers can use either actual expenses or the state and local sales tax tables to figure the sales tax deduction.

Actual Expenses

Generally, a taxpayer deducts the actual state and local general sales taxes (including compensating use taxes) if the tax rate was the same as the general sales tax rate. However, sales taxes on food, clothing, medical supplies, and motor vehicles are deductible as a general sales tax even if the tax rate was less than the general sales tax rate.

> **PLANNING TIP:** If a taxpayer paid sales tax on a motor vehicle at a rate higher than the general sales tax rate, he can deduct only the amount of tax that he would have paid at the general sales tax rate on that vehicle. This also includes sales taxes on a leased motor vehicle, but not on vehicles used in a trade or business.

Optional State Sales Tax Tables

Alternatively, instead of using actual expenses, a taxpayer can figure his state and local general sales tax deduction using IRS optional state sales tax tables, based on average consumption by taxpayers on a state-by-state basis taking into account filing status, number of dependents, adjusted gross income (plus certain nontaxable items), and rates of state and local general sales tax.

Taxpayers who use the IRS tables can add actual sales taxes paid with respect to the purchase of motor vehicles, boats, aircraft, homes (including mobile and prefabricated homes), and materials used to build a home (if the taxpayer is considered the general contractor).

> **NOTE:** For help in calculating the sales tax deduction, a sales tax calculator is available at **www.irs.gov/Individuals/Sales-Tax-Deduction-Calculator**.

State and local real estate taxes levied for general public welfare are deductible if the tax is based on the assessed value of the property and charged uniformly against all property in the taxing authority's jurisdiction [Reg. §1.164-4(a)]. To be deductible, a governmental body must impose the taxes.

Taxes charged for local benefits or improvements that tend to increase a taxpayer's property value are not deductible [IRC Sec. 164(c)(1)]. A tax is considered assessed for local benefits when property assessed with the tax is limited to property benefited [Reg. §1.164-4(a)] and it is not necessary for the property's value to actually increase.

Cooperative housing (Coop) tenant-stockholders can deduct their proportionate share of real estate taxes. (PLR 201232018)

> **CAUTION:** Deductible real estate taxes do not include itemized charges for services (such as trash collection) assessed against specific property or certain people, even if the charge is paid to the taxing authority. Likewise, payments to homeowner associations are not deductible (Rev. Rul. 76-495).

However, assessments to meet maintenance or repair costs or interest charges for the local benefit are deductible (if the taxpayer can substantiate them) as taxes because such expenditures do not tend to increase property values [Rev. Rul. 79-201; Reg. §1.164-4(b)(1)].

NOTE: Of key importance in evaluating a real estate tax deduction is whether the payer of the tax is a “beneficial or equitable owner of the property” under state law. See discussion that follows.

Real estate taxes are deductible for all property owned by a taxpayer. Refunds of real estate taxes paid must be handled carefully:

1. If a refund is received in the same year the tax is paid, net the two against each other on Schedule A, or
2. If the refund is received in a later year, report it as miscellaneous income, subject to the tax benefit doctrine.

If a buyer of property pays a seller’s delinquent taxes, they are not currently deductible and are, instead, added to the basis of the property.

PLANNING TIP: Taxpayers can elect on unimproved real property to capitalize carrying charges that normally would be deductible [IRC Sec. 266; Reg. §1.266-1(c)], including taxes. This election is useful when a taxpayer uses the standard deduction or would otherwise receive little or no benefit, perhaps, because of AMT or an NOL carryforward. Regs. 1.266-1(b)(1) and (2) state that the election may be made for items expressly deductible under the provisions of subtitle A of the Internal Revenue Code and that no election may be made for an item not otherwise deductible. Carrying charges (such as insurance) would be considered a Section 212 expense, which would be a miscellaneous itemized deduction subject to the 2% AGI floor. No guidance has been issued on whether the effect of the TCJA to suspend the deduction for miscellaneous itemized deductions subject to the 2% AGI floor under IRC Sec. 67(g) will affect the ability to make a Section 266 election for these expenses from 2018-2025.

State and local personal property taxes are deductible if they are [Reg. §1.164-3(c)]—

1. Based on the value of the property,
2. Imposed on an annual basis, and
3. Imposed in respect of the property.

NOTE: A tax can qualify even if it is for the exercise of a privilege (e.g., a motor vehicle registration fee), if it meets the above qualifications.

Other Taxes

Line 6 of Schedule A is for other taxes. According to the instructions to the form, this line is for income taxes paid to a foreign country and generation skipping tax (GST) imposed on certain income distributions. The deduction for foreign income taxes can be taken in lieu of the foreign tax credit.

QUALIFIED RESIDENCE INTEREST

Generally, "qualified residence interest" (the mortgage interest deduction) is an itemized deduction for any interest paid on a loan secured by a taxpayer's qualified residence (main home or a second home). The loan may be a mortgage to buy the home or a second mortgage. The deduction for mortgage interest must be reduced by any mortgage interest credits claimed on Form 8396 (Mortgage Interest Credit).

The TCJA permits a deduction on home acquisition indebtedness up to $750,000 ($375,000 married filing separate) for tax years beginning after December 31, 2017 and before January 1, 2026.

The prior $1,000,000 ($500,000 married filing separate) limit stays for loans taken out on or before December 15, 2017, or under a binding contract that was in effect before December 15, 2017, to close on January 1, 2018, and is purchased before April 1, 2018.

A second grandfather clause continues to apply for home acquisition indebtedness that was taken out on or before December 15, 2017 and then is refinanced later, if the new loan does not exceed the principal balance of the prior loan at the time of the refinancing.

Unmarried co-owners of qualified residences have a distinct advantage under the limits, as the limits are based on a per-individual basis not a per-residence basis.

COURT CASE: In *Voss*, both 50% owners were each entitled to claim up to $750,000 of home acquisition debt. The court stated, "we [. . .] agree that the debt limit provisions result in a marriage penalty [. . .] but did not similarly provide lower debt limits for unmarried co-owners." The IRS subsequently announced that it will follow the 9th Circuit's ruling going forward and apply the limitation on a per-individual basis and not per-residence. (*Voss v. Comm.*, 116 AFTR 2d 2015-5529, 8/7/15; IRB 2016-31, p. 193)

General Rules

A taxpayer cannot deduct interest paid on behalf of another person. Reg. §1.163-1(b) states in part that "interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his or her indebtedness."

COURT CASE: If a taxpayer can establish legal, equitable, or beneficial ownership of mortgaged property, they may be entitled to a deduction for qualified residence interest. In *Uslu v. Comm.* (T.C Memo. 1997-551), the taxpayers could not qualify for a mortgage loan because of a recent bankruptcy. Consequently, the taxpayer and his brother agreed that the brother would obtain the loan for the property and the taxpayers would pay the mortgage and all other expenses for maintenance and improvements. The Court held that although the taxpayers did not hold legal title to the property, they were the equitable owners and were entitled to deduct mortgage interest they paid with respect to the property.

COURT CASE: In *Wainwright v. Comm.* (TC Memo. 2017-70), the taxpayer lived with a friend. The home was originally purchased by the friend. The original owner and the taxpayer refinanced the property as co-borrowers to make renovations. The taxpayer resided in and maintained the property, made monthly mortgage payments, and received a Form 1098. The IRS disallowed the deductions claiming that the taxpayer was not the legal or equitable owner of the property. The Tax Court disagreed, finding the taxpayer had an equitable ownership interest in the home because he assumed the benefits and burdens of ownership under state law.

A bona fide debtor-creditor relationship must exist. In a heartbreaking case, a taxpayer was denied a mortgage interest deduction because his mother never recorded the mortgage as a lien, and therefore did not secure the debt (*DeFrancis*, TC Summary Opinion 2013-88).

A qualified residence must secure acquisition and home equity indebtedness (if otherwise allowable).

NOTE: A taxpayer can deduct home mortgage interest only if the mortgage is a secured debt. A secured debt is one in which an instrument is signed (such as a mortgage, deed of trust, or land contract) that makes ownership in a qualified home security for payment of the debt, and provides, in case of default, that the home could satisfy the debt, and is recorded or is otherwise perfected under any state or local law that applies. In other words, a mortgage is a secured debt only if a home is put up as collateral to protect the interests of the lender. Wraparound mortgages are not considered secured unless they have been recorded or perfected under state law.

A *qualified residence* can be a taxpayer's principal residence and one other residence selected by the taxpayer for any particular tax year [IRC Sec. 163(h)(4)(A)]. Principal residence has the same meaning as under IRC Sec. 121, dealing with the home sale gain exclusion; there must be bathroom facilities, sleeping facilities and kitchen facilities. The definition includes a house, condo, co-op, mobile home, house trailer or boat. When a taxpayer uses more than one home as a residence throughout a year, the home used the most during the year is generally the principal residence.

COURT CASE: A taxpayer was unable to claim interest expense on a 2nd home, located in Syria, due to his inability to show that property was a "qualified residence" that he occupied for more than 14 days and/or failed to rent out during year. The taxpayer did not establish a mortgage note existed or that he was liable on a mortgage note and did not produce a certificate of title or any other documentary evidence that he owned the property (*Al-Soufi v. Comm.*, TC Memo 2015-68).

If a taxpayer has several homes in addition to a principal residence, the taxpayer may designate a different home as the second qualified residence each year [Temp. Reg. §1.163-10T(p)(3)(iv)].

When a residence is rented for part of the year, it is treated as a qualified residence only if the taxpayer uses it for personal purposes for a number of days that exceeds the greater of [IRC Secs. 163(h)(4)(A)(i)(II) and 280A(d)(1)]—

1. 14 days, or
2. 10% of the number of days the unit was rented at a fair rental rate.

If a second residence is not rented (or held out for rent) during the year, it qualifies even if the taxpayer has no days of personal use during the year [IRC Sec. 163(h)(4)(A)(iii)].

Vacant Land

Vacant land used for occasional camping does not qualify as a residence (*Garrison*).

Substantial Improvement

An improvement is substantial if it—

1. Adds to the value of the home,
2. Prolongs the home's useful life, or
3. Adapts the home to new uses.

> **PLANNING TIP:** Repairs that maintain a home in good condition, such as repainting, are not substantial improvements. However, if a taxpayer paints a home as part of a renovation that substantially improves a qualified home, it may be included in the cost of the improvement.

Mortgage Interest

Mortgage interest must be actually paid. In *Hargreaves* (TC Summ. Op. 2013-37), the Tax Court held a married couple could not deduct mortgage interest that was added to the principal of their negative amortization loan. Since they were cash basis taxpayers, they couldn't deduct what they did not pay. In *Smoker* (TC Memo 2013-56), the Tax Court held that a cash-basis taxpayer could not deduct residence interest that was capitalized into the mortgage principal rather than paid. Similarly, in *Fargo* (T.C. Memo 2015-96), the Court ruled that negative amortized interest paid through refinancing is disregarded in computing an allowable deduction.

A mortgage secured by a qualified home may be treated as home acquisition debt, even if a taxpayer does not actually use the proceeds to buy, build, or substantially improve the home. (See the Special 90-Day Rule for Expenditures on a Residence discussion later in this chapter.)

A taxpayer can elect to treat debt as not secured [Temp. Reg. §1.163-10T(o)(5)]. This election is effective for all subsequent years and can only be revoked with IRS consent.

When a secured debt exceeds the legislative limitations of $750,000 (or if applicable, $1 million), a taxpayer may be able to use the tracing rules to allocate the excess interest to business interest deductible on Schedule C or F. A taxpayer must use the Pub. 936 worksheet (simplified method) to allocate excess interest under the interest tracing rules of Temp. Reg. §1.163-8T, with no need to make the election under Temp. Reg. §1.163-10T(o)(5) [CCA 201201017)].

Certain other payments also qualify as mortgage interest including late payment fees (unless they are a collection fee), prepayment penalties, and mortgage interest paid by a minister, even when the minister qualifies for a housing allowance.

HOME EQUITY INTEREST

The TCJA disallows home equity or line of credit indebtedness interest. Essentially, the previous $100,000 home equity limit has been eliminated. However, the IRS has stated that interest paid on home equity loans and lines of credit are still deductible if the funds are home acquisition indebtedness (IR

2018-32). That is, loan proceeds are used to buy, build or substantially improve the house. In other words, it will be part of the $750,000 limit mentioned above. The previous $100,000 equity loan limit is eliminated.

If the interest can be traced to other uses such as trade or business, it would be better to treat the interest expense under the general tracing rules rather than under the home equity debt rules. This allows a taxpayer to take a deduction that would otherwise go unused. It may also reduce self-employment income, which reduces self-employment (SE) tax, and adjusted gross income (AGI), which may change income exclusions, itemized deductions, or credits that are impacted by AGI.

Taxpayers can irrevocably elect to treat debt as not secured by a qualified residence [Temp. Reg. §1.163-10T(o)(5)]. The impact of this election is that the general tracing rules of Temp. Reg. §1.163-8Tapply to determine the tax treatment of the interest expense. The regulations are actually silent as to whether a formal election is necessary.

INTEREST ALLOCATION AND TRACING

American taxpayers have been using the equity in their homes to purchase personal items, services or pay off personal debt, fund trades or businesses or purchase investments. With the elimination of the home equity provision and the new lower limits on acquisition indebtedness, practitioners may want to pay attention to the use of loan proceeds going forward.

Ideally, interest tracing is simple if borrowings used for different expenditures are segregated into individual accounts or the proceeds are paid directly to the seller of the intended property or services.

Taxpayers must track (i.e., keep records of) the use of loan proceeds to determine the type of interest paid. Unfortunately, borrowings will often be comingled with other funds which makes the tracing of the use of the funds more difficult. This is where the interest tracing rules come into play.

When funds are commingled, Temp. Reg. §1.163-8T prescribes a series of allocation rules to match borrowings with expenditures. These rules are separately applied to each account and are summarized as follows:

1. If borrowed funds are deposited into an account already containing unborrowed funds, the borrowed funds are presumed to be expended first. Unborrowed funds deposited after borrowed funds will be presumed to be expended after the borrowed funds have been exhausted.

2. When borrowed funds from several loans are deposited into an account at different times, the funds from the earliest loan are presumed to be expended first (FIFO concept).

3. When borrowed funds from several debts incurred together are simultaneously deposited into an account, the taxpayer can select the order the funds are presumed to be deposited into the account. (No formal election is required.)

4. Except under the previously discussed 30-day rule, expenditures *will not* be attributed to borrowed or unborrowed funds deposited into an account after the expenditure.

5. The collateral for the debt is generally irrelevant except for the purpose of the qualified residence interest expense. Interest is not deductible to the extent the loan is secured by a tax-exempt obligation (Rev. Proc. 72-18) or single premium annuit contract (Rev. Rul. 95-53).

6. Unexpended debt proceeds deposited in an account are presumed held for investment. As of the date the funds are spent, their character is reallocated based on the type of expenditure (passive, business, etc.). However, solely for reallocation purposes, the taxpayer can treat the expenditure as occurring on the later of the first day of the month the expenditure was made or the date the loan proceeds were deposited.

EXAMPLE: Treatment of Loan as Property Held for Investment

Angela borrows $100,000 on January 4th, which she deposits in a separate checking account. No other amounts are deposited in the account during the year and no part of the loan principal is repaid during the year. On April 2nd, she uses $20,000 from her checking account for a passive activity expenditure. On September 4th, she uses $40,000 from the account for personal purposes.

Under the interest allocation rules, the entire $100,000 loan is treated as property held for investment for the period from January 4th through April 1st. From April 2nd through September 3rd, she must treat $20,000 of the loan as used in a passive activity and $80,000 of the loan as property held for investment. From September 4th through December 31st, she must treat $40,000 of the loan as used for personal purposes, $20,000 as used in a passive activity, and $40,000 as property held for investment.

The 30-Day Rule Exception

A taxpayer can treat any expenditure from an account within 30 days before or after debt proceeds are deposited as made from the deposited debt proceeds, to the extent of such proceeds (IRS Notice 89-35).

This treatment overrides the general tracing rules and can be beneficial if it results in expenditures being treated as other than personal.

In addition, when a taxpayer receives debt proceeds in cash (i.e., the funds are not deposited in an account), the presumption is that they are used for personal expenditures. However, if the taxpayer makes a cash expenditure (including a deposit to an account) within 30 days before or after receiving the debt proceeds in cash, he can treat it as being made from the debt proceeds.

No formal election statement is required to use the 30-day rule. However, taxpayers should document their decisions. Whether or not the 30-day rule is used in classifying debt, documenting the treatment of expenditures made 30 days before and after depositing debt proceeds will prevent confusion in later years.

Special 90-day Rules for Expenditures on a Residence

<u>Acquisition of a Residence</u>

Under the 90-day rule, taxpayers may treat debt as incurred to acquire a residence to the extent payments are made to acquire it within 90 days before or after the date the debt is incurred (IRS Notice 88-74). This rule overrides the general interest tracing rules of Temp. Reg. §1.163-8T (and the 30-day rule previously discussed).

Construction or Substantial Improvement of a Residence

In addition, when a residence is being constructed or substantially improved, debt incurred before the completion of the project can be treated as incurred to construct or improve a residence to the extent such expenditures are made no more than 24 months before the date the debt is incurred [Temp. Reg. §1.163-10T(p)(5)]. Debt incurred within 90 days after completion of the construction or improvements can also be treated as incurred to construct or improve the residence to the extent of any expenditure to construct or improve the residence made (1) no more than 24 months before the completion of the project, and (2) after completion up to the time the debt is incurred. This 90-day rule also overrides the result that occurs from a literal application of the interest tracing rules of Temp. Reg. §1.163-8T (and the 30-day rule). [Notice 88-74]

When the residence is completed depends on all the facts and circumstances. For these 90-day rules, debt is incurred when loan proceeds are disbursed to or for the benefit of the taxpayer. Alternatively, a taxpayer may treat the loan application date as the date the debt is incurred, provided it is disbursed within a reasonable time after loan approval (i.e., generally 30 days).

As discussed earlier under **Qualified Residence Interest**, debt qualifying under these rules must be secured by a qualified residence before the interest will be treated as qualified residence interest.

When new debt is used to pay accrued interest on other loans, it is allocated as are the loans generating the accrued interest [Temp. Reg. §1.163-8T(c)(6)(ii)]. *However*, cash-basis taxpayers cannot deduct interest expense paid from the proceeds of a loan from the same lender if the purpose of the second borrowing is to obtain funds to pay the first loan (*Charles Copeland, et ux. v. Comm.*, TC Memo 2014-226). Instead, the interest is deferred until the second borrowing is repaid. This rule does not apply if—

1. The proceeds from the second loan are commingled with the taxpayer's other funds,
2. The taxpayer has additional funds from which to pay the interest, and
3. The second borrowing was not incurred to pay the accrued interest on the first debt (Ltr. Rul. 8415002).

EXAMPLE: IRS Notice 88-74 Illustration

Tim incurs a debt of $100,000, the proceeds of which are used to purchase a residential lot on January 15, 2019. The debt is secured by the lot. On January 1, 2020, Tim begins construction of a residence on the lot. Tim spends $250,000 of unborrowed funds to construct the residence. The residence is complete on December 31, 2021, and, at that time, the residence becomes Tim's principal residence. On March 15, 2022, Tim incurs a debt of $300,000 secured by the residence. The lender on the second debt disburses $100,000 to pay off the existing debt and disburses the remaining $200,000 directly to Tim. Tim has no other debt secured by a qualified residence.

Analysis: The $100,000 debt that was incurred in 2019 is incurred to construct the residence because the proceeds of the debt are directly traceable to expenditures to construct the residence (i.e., the purchase of the lot). During the period January 15, 2019–December 31, 2019, since Tim has not occupied the residence, he may not treat the debt as acquisition indebtedness because it is not secured by a qualified residence.

During the period January 1, 2020–December 30, 2021, Tim may treat the residence under construction as a qualified residence [IRC 1.163-10T(p)(5)]. Accordingly, the debt may qualify as acquisition indebtedness. During the period December 31, 2021–March 15, 2022, the residence is a qualified residence, and the debt will qualify as acquisition indebtedness.

The $300,000 debt is also incurred to construct the residence. $100,000 of the debt is treated as debt incurred to construct the residence because was used to refinance debt incurred to construct the residence; the remaining $200,000 of the debt is treated as debt incurred to construct the residence because it was incurred within 90 days after the residence was complete, and construction expenditures of at least such an amount were incurred within the period beginning with the date 24 months prior to the date the residence was complete and ending with the date the debt was incurred. The entire $300,000 debt is acquisition indebtedness because it is also secured by a qualified residence. Therefore, all the interest on the debt is deductible as qualified residence interest.

Variation: The facts are the same, except that rather than incurring a debt to purchase the lot, Tim uses cash to purchase the lot. In this case, since none of the $300,000 debt was used to refinance a debt incurred to construct a qualified residence, the debt may be treated as incurred to construct the residence only to the extent of the $250,000 in expenditures that were incurred during the period beginning on the date 24 months prior to the date the residence was complete and ending on the date the debt was incurred. The expenditure to purchase the lot was made prior to that period and, accordingly, the debt may not be treated as incurred to pay for that expenditure.

Accordingly, $250,000 of the debt incurred on March 15, 2022, may be treated as incurred to construct the residence and, therefore, will qualify as acquisition debt. Because the debt is secured by a qualified residence, the remaining $50,000 of the debt will qualify as home equity indebtedness (now suspended under TCJA).

OBSERVATION: In the Example Variation, the debt used to refinance the lot was not treated as acquisition indebtedness because it was acquired beyond the 24-month period allowed under the 90-day rule. The cost of the lot is still part of the taxpayer's basis in the property.

REPAYMENT ORDERING RULES FOR MULTIPLE-USE DEBT

Often, proceeds from a single debt will be allocated to several different categories of expenditures (e.g., personal, passive activity, trade, or business). When such a debt is partially repaid, ordering rules determine which category is deemed repaid first. Repayments are allocated to the various expenditure categories in the following order (which is favorable to taxpayers) [Temp. Reg. §1.163-8T(d)]:

1. Personal expenditures.
2. Investment expenditures and expenditures for passive activities (other than rental real estate activities for which the taxpayer meets the active participation test).
3. Expenditures for rental real estate activities for which the taxpayer meets the active participation test.
4. Expenditures for former passive activities.
5. Expenditures for trade or business activities or certain low-income housing projects.

HOME MORTGAGE INSURANCE PREMIUMS (PMI)

Premiums paid or accrued for “qualified mortgage insurance” in connection with home acquisition debt, where the insurance contract was issued after 2006 is deductible as home mortgage interest [IRC Sec. 163(h)(3)(E)]. This provision expired at the end of 2017 but was retroactively extended to 2018, 2019 and 2020 by the Taxpayer Certainty and Disaster Tax Relief of 2019 (2019 Disaster Act). The CAA extended the deduction through 2021.

The deduction is phased out ratably by 10% for each $1,000 ($500 for married filing separate), or fraction thereof, by which the taxpayer's AGI exceeds $100,000 ($50,000 for married filing separate). Thus, the deduction is unavailable for taxpayers with an AGI exceeding $109,000 ($54,500 for married filing separate) [IRC Sec. 163(h)(3)(E)(ii)]. This limitation is not adjusted for inflation.

EXAMPLE: Treatment of PMI Payments under Phase-Out Rules

Tim and Jane are married and filing jointly for the tax year 2020. The amount allocable to 2020, for qualified mortgage insurance, is $1,500 and their AGI is $104,000. Consequently, they are $4,000 into the $10,000 phase-out range (40%). Their deduction for qualified mortgage insurance must be reduced by 40%, or $600. Therefore, their deduction is $900 ($1,500 less $600).

MORTGAGE LOAN POINTS

Points charged for the use of money are deductible as qualified residence interest expense if associated with qualified residence acquisition indebtedness or home equity indebtedness. For this purpose, points include amounts [Rev. Proc. 94-27]:

1. Designated as such on a Form HUD-1 Uniform Settlement Statement (e.g., loan origination fees, loan discount, discount points, or points),
2. Computed as a percentage of the loan amount,
3. Charged under the established business practice in the area the residence is located, and
4. Paid in connection with the acquisition of the taxpayer’s principal residence.

IRC Sec. 461(g)(2) allows (but doesn’t mandate) cash-basis taxpayers to deduct prepaid points upon payment if—

1. The points are paid on indebtedness incurred from the purchase, construction, or improvement of a principal residence (second home or home equity loan points do not qualify), and
2. The indebtedness is secured by a principal residence, charging points is an accepted business practice, and the points charged are not excessive in relation to normal business practices.

EXAMPLE: Treatment of Points Paid When Taking the Standard Deduction

During December, Buck buys a new home in Ohio with a $100,000 mortgage. He pays $2,000 in points (2% of loan amount). While preparing his tax return, he discovers that he cannot itemize and will take the standard deduction. He can amortize the points over the life of the loan.

Points related to debt on a second home meeting the definition of a *qualified residence* must be amortized over the life of the loan.

PLANNING TIP: Points are deductible (either currently or via amortization) only to the extent they are paid (or deemed paid) by the taxpayer. In connection with the purchase of a principal residence, all amounts paid by the taxpayer in connection with the closing are treated as if applied to the points charged (Rev. Proc. 94-27).

Taxpayers are deemed to have paid points directly to the extent of down payments, escrow deposits, earnest money applied at closing, and other amounts actually paid at closing. However, it appears this rule applies only to purchases of a principal residence. Points paid for the improvement of a principal residence must be paid from separate funds a taxpayer brings to the loan closing to be deductible.

A buyer may deduct seller-paid points so long as the amount of the seller-paid points is deducted from the purchase price when computing the basis of the residence (Rev. Proc. 94-27).

Points paid for a *mortgage refinancing* are not deductible when paid but must be capitalized and amortized over the term of the new loan (Rev. Rul. 87-22).

Amortization is computed ratably based on the number of periodic loan payments made in the tax year to the total periodic payments for the term of the loan (Rev. Proc. 87-15). If a loan is paid off prior to maturity (e.g., the residence is sold, and the loan paid off, or the loan is refinanced), the remaining unamortized balance of the points can be deducted in that tax year (PLR 8637058).

If a mortgage loan is refinanced with the same lender, the unamortized points on the first loan must generally be deducted over the term of the new loan (IRS Pub. 936). However, if a borrower paid an amount at least equal to the points at closing of the first refinancing (i.e., the loan to which the unamortized points relates) and that loan is subsequently refinanced with a different lender, it appears that the unamortized points can be deducted in the year of the subsequent refinancing.

EXAMPLE: Treatment of Points Paid on a Second Refinance Loan

Pete refinanced his existing home loan of $300,000 in January to get a 4.0% loan. He paid points of $6,000. His mortgage broker suggested he refinance a few months later, in July, to get a lower rate of 3.25% at a cost of $5,000, which he did. Can Pete deduct the entire $6,000 and amortize the $5,000 over the life of the new loan?

Answer: Yes, providing the second refinance is with a different mortgage lender according to IRS Pub 936. The issue is whether the points were actually paid when the first refinance occurred. If the taxpayer paid the points when he refinanced in January, one could argue they would now be deductible even if using the same lender to refinance. The use of a different lender causes the points to be “paid” on the second refinance.

INVESTMENT INTEREST EXPENSE

Interest paid on money borrowed to buy investment property qualifies for deduction as investment interest. *Investment property* is defined as—

1. Property that produces interest, dividends, annuities, or royalties, not in a trade or business,

2. Property that produces gain or loss from the sale or trade of investment property, or

3. An interest in a trade or business that is not a passive activity and in which the taxpayer does not materially participate (IRC 163(d)(5)(A)(ii)).

Investment interest *does not* include home mortgage interest, interest from a passive activity, interest that is capitalized, or interest related to tax-exempt interest income.

Investment interest expense is deductible only to the extent a taxpayer has net investment income (i.e., investment income less investment expenses).

Investment income includes interest, non-qualified dividends, annuities, and royalties.

Capital Gains and Qualifying Dividends

Capital gains and/or qualifying dividends, if elected on Form 4952 [IRC Sec. 163(d)(4)(B)], considered as investment income are not eligible to be taxed at the preferential capital gains rates.

PLANNING TIP: This election generally should not be made if a taxpayer has enough current or projected investment income (without considering net capital gains or qualified dividends) to allow a deduction of all investment interest expense. Ultimately, when deciding whether to make the election, consider the client's current-year and projected ordinary and long-term capital gain rates and projected net investment income for future tax years. The time value of money related to current tax savings should also be considered.

Even if investment interest expense is limited, the disallowed amount generally carries over indefinitely. Typically, the election will only make sense if the taxpayer does not anticipate generating enough investment income (other than qualified dividends and net capital gains) to offset his or her investment expense for several years. Also, an election is more likely to benefit a taxpayer whose ordinary income is taxed at relatively low rates, since a smaller spread between the long-term and ordinary income rates decreases the election's cost (i.e., additional tax on elected income.

Disallowed investment interest expense is automatically carried forward indefinitely and treated as investment interest in the carryforward year. A taxpayer has no choice.

COURT CASE: In *Pugh*, the Tax Court has held that interest on a loan that was used to purchase land on which the individual taxpayer intended to locate his business, but didn't because his business revenues decreased significantly, was deductible as business interest. Mr. Pugh was a sole proprietor of Pi which was engaged in the business of software development. The business was conducted from his home. In 2006, the business was doing well, and he purchased two vacant lots. He also purchased two steel buildings, disassembled them and stored the components on one of the properties. He was planning to re-assemble the buildings and have them serve as Pi's headquarters. Unfortunately, he lost a major customer and was unable to follow through on his plans. As of the date of the trial, some of the properties were sold, remained undeveloped and some of the components of the steel buildings were sold as scrap. For the years in question 2010 and 2011, he deducted the interest on his Schedule C. The court held that the interest was neither investment interest or personal and therefore allowed it to be deducted as business interest even though the properties were never used in the taxpayer's business. (*Pugh v. Comm.*, TC Summary Opinion 2019-2)

CHARITABLE CONTRIBUTIONS OVERVIEW

A charitable contribution is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without receiving or expecting to receive anything of value in return.

Qualified organizations include nonprofit groups that are religious, charitable, educational, scientific, or literary in purpose, or that work to prevent cruelty to children or animals. The Exempt Organizations Select Check Tool on the IRS's website can help clarify whether an organization qualifies for charitable contributions and what percentage limitation (discussed below) applies (www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check).

> **PLANNING TIP:** Rev. Proc. 2018-32 gives easily accessible guidance to grantors and contributors and allows reliance on the IRS database to identify an organization's tax exempt or public charity status.

A taxpayer may deduct a contribution only in the year actually paid in cash or other property. The dates deemed paid depend on the payment method:

1. Checks—the date mailed, assuming it clears [Reg.1.170A-1(b)].
2. Credit card—the date the charge is made [Rev. Rul. 78-38].
3. Pay-by-phone account—the date the financial institution pays the account.
4. Promissory note—if the taxpayer issues a promissory note to the organization, the date the note is paid.
5. Borrowed funds—if the taxpayer borrows money and then donates the funds to an organization, the date the contribution is made, regardless of when the loan is repaid.

The charitable contribution deduction allowed in a year is based on a taxpayer's contribution base (i.e., the taxpayer's AGI without regard to NOL carrybacks) [IRC Sec. 170(b)(1)(F)].

The amount of charitable contributions an individual can deduct in a year is limited depending on the types of organizations to which the contributions were made, the kinds of property contributed, and the amount or value of the donated property.

Under the TCJA, the cash charitable contribution deduction to public charities was increased to 60% for 2018 increasing the limit from 50%, of an individual's AGI, prior to any NOL carryback. The CARES Act removed the 60% limitation for cash contributions made to public charities in 2020 (qualifying contributions). The CAA extended this provision for 2021. Accordingly, an individual's qualifying cash contributions, reduced by other contributions, can be as much as 100% of the contribution base (AGI). No connection between the contributions and COVID-19 activities is required.

50% Limitations

The first 50% limitation provides aggregate deductible contributions, including those subject to the separate 20% or 30% limitations. It cannot exceed 50% of AGI.

The limitation refers to gifts (other than capital gain property) to certain 50% charities (they retained this name under TCJA), including churches, schools, hospitals, governmental entities, private operating foundations, and other nonprofit agencies organized for charitable, religious, educational, scientific, or literary purposes [IRC Sec. 170(b)(1)(A)].

Excess contributions are carried over to the succeeding five tax years and are used on the FIFO basis [IRC Sec. 170(d)]. However, for any tax year, all current-year contributions are deducted first.

30% Limitations

The first, “regular” 30% limitation applies to gifts of property (including cash) other than capital gain property to 30% charities, including veterans’ organizations, domestic fraternal societies, nonprofit cemeteries, and certain private foundations [IRC Sec. 170(b)(1)(B)].

The second, “special” 30% limitation applies to gifts of capital gain property to a 50% charity [IRC Sec. 170(b)(1)(C)]. The special 30% limit *does not* apply when a taxpayer chooses to limit the deduction to the tax basis of the property; only the 50% limit applies. The special 30% limit also does not apply to qualified conservation contributions, discussed later.

Unused 30% contributions are carried over to the succeeding five tax years and retain their character as either “special” or “regular” 30% contributions [IRC Sec. 170(b)(1)(B)].

20% Limitations

The 20% limitation applies to gifts of capital gain property to non-50% charities (e.g., most family-funded private foundations) [IRC Sec. 170(b)(1)(D)]. The 20% limit is applied after considering the 50% and 30% limits (if any) for a tax year. The deductible amount of 20% contributions is limited to the lesser of—

1. 50% of AGI reduced by 50% contributions and regular 30% contributions,
2. 30% of AGI reduced by special 30% contributions, or
3. 20% of AGI.

Excess 20% contributions are carried over to the succeeding five tax years and retain their 20% character [IRC Sec. 170(b)(1)(D)(ii)].

NOTE: If a taxpayer's total contributions for a year to qualified charities total 20% or less of AGI, the percentage limitations (i.e., 50%, 30%, and 20%) will not apply.

EXAMPLE: Determining the Limitation Percentage of Charitable Donations

Melinda’s current year AGI is $100,000. During the year, she gave her church (a 50% charity) $4,000 cash and land with a FMV of $60,000 and a basis of $44,000. The land is capital gain property. The donation of the land is subject to the special 30% limitation. She also gave $5,000 of capital gain property to a private foundation subject to the 20% limitation.

The cash contribution is considered first since it was made to a 50% charity. For 2020/2021 cash contributions to a applicable public charity can be up to 100% of AGI reduced by other contributions.

Melinda's donation of land is subject to the special 30% of AGI limit. It is included at FMV ($60,000) in applying the 30% limitation. Therefore, Melinda can deduct a maximum of $30,000 for the land donation. The unused special 30% contribution ($30,000) is carried over to later years. The $5,000 contribution to the private foundation is subject to the 20% limitation but is nondeductible because the limitation is reduced to zero because of the full use of the special 30% limitation. It carries over for up to five years.

Melinda's current deduction is limited to $34,000 ($4,000 + $30,000). Both carryovers will continue to be subject to the special 30% and 20% limit, respectively.

Carryover Rules

Unused contributions are carried over five years and are subject to the same percentage limitations that applied originally. In carryover years, current year contributions are deducted first, and carryovers are on the FIFO basis. Carryover gets reduced even when not itemizing deductions. A surviving spouse cannot use carryovers allocable to a deceased spouse after the year of death.

NOTE: There is a special 15-year carryover for qualified conservation contributions.

For appreciated capital gain property, if the sale of property on the date contributed would have resulted in long-term capital gain:

1. Generally, the charitable deduction equals the FMV of the property. Examples include stocks, bonds, jewelry, real property, depreciable property, personal automobiles and furniture.

2. However, there are exceptions. A deduction for gifted capital gain property must be limited to its tax basis if it is—

    a. Property contributed to certain private non-operating foundations,

    b. Tangible personal property put to an unrelated use by the charitable organization, or

    c. 50% AGI limit is used instead of the 30% limit for capital gains.

COURT CASE: An artist was denied a noncash charitable contribution deduction for artwork (postcards) contributed to charity. The court upheld the disallowance of the charitable deduction. IRC Sec. 170(e)(1)(A) limits the charitable deduction to a taxpayer's basis if the gain recognized by the taxpayer would be treated as ordinary income had it been sold by the taxpayer. No cost or basis could be determined by the court. (*Kaplan v. Comm.*, TC Memo 2016-149)

PLANNING TIP: For investment property that has increased in value (capital gain), donate property and deduct the full FMV (less allowable depreciation), even though property is not reported as income.

For investment property that has decreased in value (capital loss), if the property itself is donated, only the charitable donation at FMV is realized. Sell the property and donate the proceeds. This generates a capital loss from the sale and a charitable deduction for the donation.

Noncash Contributions

For noncash contributions of used clothing and household items:

1. Deductions may not be taken for donations of used clothing and household items that are not in "good used condition or better" (unless appraised). Note that this rule applies only to used clothing and household items. Art, collectibles, and other non-household items are not subject to this rule.

2. The law does not define what "good" is.

COURT CASE: Taxpayers were not entitled to a deduction of $145,250 for gifts to charity "other than by cash or check." The IRS disallowed all but $250 of the deduction. The taxpayers alleged that they donated more than 20,000 distinct items of property to Goodwill. Furthermore, similar items of property must be aggregated in determining whether gifts exceed the $500 and $5,000 thresholds, and, of course, the taxpayer could not produce a single qualified appraisal. The court also upheld the 20% accuracy penalty. (*Ohde v. Comm.*, TC Memo 2017-137)

A charitable deduction is reduced by the FMV of goods or services received from the charity. Certain goods and services may be disregarded, such as:

1. Annual membership benefits up to $75 per year.

2. Goods with an insubstantial value where the benefits are the lesser of 2% of the amount contributed or $113 for years beginning in 2021(up from $112 in 2020); the amount contributed is $56.50 or more for years beginning in 2021 and benefits do not exceed $11.30; or taxpayer receives free unordered benefits that do not exceed $11.30. [Rev. Proc. 2019-44]

LAW CHANGE ALERT: As a result of the TCJA, donations to a college or university for the right to buy tickets to athletic events are no longer deductible for tax years beginning after December 31, 2017. This was formerly an 80% deduction in 2017.

EXAMPLE: Determining Reduction of Charitable Contribution

Nittany donates $1,000 to her alma mater. In return, Penn State University sends her a set of personalized coffee mugs valued at $50. Nittany can deduct $950.

EXAMPLE: Determining When a Charitable Contribution Cannot Be Deducted

Hoosier donates $20,000 to the Indiana University and has the right to buy Indiana season basketball tickets. Hoosier cannot deduct any of the amount.

Use of Personal Auto

The standard mileage rate for an auto in rendering gratuitous services to a charity is statutory at $ .14 per mile.

CHARITABLE DOCUMENTATION REQUIREMENTS

CAUTION: Special rules exist for the gifts of conservation easements, vehicles, boats, aircraft, and volunteer services for charities. Please see **Special Situations—Charitable Contributions and Conservation Easements** later in this chapter.

Gifts of Cash—Any Amount

A donor will not be allowed any deduction for a contribution of cash, by check, or any other monetary gift regardless of the amount unless the donor retains either:

1. A bank record that supports the donation, or

2. A written receipt or communication from the charity showing the name of the donee organization, date, and amount of the contribution [IRC Sec. 170(f)(17)].

A *monetary gift* includes the transfer of a gift card redeemable for cash and a payment made by credit card, electronic fund transfer, an online payment service, or payroll deduction [Prop. Reg. §1.170A-15(b)(1)].

A *bank record* includes a statement from a financial institution, an electronic fund transfer receipt, a cancelled check, a scanned image of both sides of a cancelled check obtained from a bank website, or a credit card statement [Prop. Reg. §1.170A-15(b)(2)].

A credit card statement must show the name of the charity, the contribution amount, and the date of contribution (INFO 2010-0153). A written communication includes electronic mail correspondence [Prop. Reg. §1.170A-15(b)(3)].

Payroll deductions can be substantiated with a pay stub, Form W-2 or other reliable written record, and a pledge card or other document provided by the charity that includes a statement indicating the organization does not provide goods or services in return for the donations made by payroll deduction [Reg. §1.170A-13(f)(11)(i)].

NOTE: Charitable cash handouts—such as cash placed on church collection plates—*will not* result in any deductions unless the donor obtains a qualifying receipt or written communication.

Each donation is viewed as a separate contribution, regardless of whether the total contributions made by the taxpayer to a donee organization reaches the $250 substantiation limit [Reg. §1.170A-13(f)(1)]. The IRS is authorized to issue rules regarding multiple donations of less than $250 if they are made to avoid the substantiation rules. However, the Regulations currently do not contain an anti-abuse provision. (See court case *Kunkle* later in this chapter.)

Gifts (Cash or Property) of $250 or More at One Time

Requires contemporaneous written acknowledgement from the charitable organization containing the following:

1. Donee's name and address.

2. Amount and description of cash and/or property contributed, date and location of contribution.

3. Statement as to whether goods or services were received from the organization and, if so, their FMV.

As indicated in item 3, the statement must also include a statement if the donor received anything in return. If the donor did receive goods or services, then the statement must include a good faith estimate of the value of the goods or services. If only intangible religious benefits (admission to services) are received no valuation of the benefit is required.

A taxpayer may obtain one written acknowledgment for multiple gifts of $250 or more to the same charity. Acknowledgements must be obtained the earlier of the date return is filed or due date of return including extensions.

COURT CASE: A church founder/pastor and his wife were denied charitable deductions above the amounts which the IRS allowed. They didn't provide Section 170(f)(8) contemporaneous written acknowledgment or other substantiation for stated donations, but instead submitted documents that were prepared after-the-fact (unverified receipts that didn't correspond to amounts claimed and uncorroborated testimony by their niece). Further, neither of them testified under oath that they did in fact make the contributions. (*Brown v. Comm.*, TC Memo. 2016-39)

CAUTION: A canceled check or other reliable record is not sufficient proof for single gifts of $250 or more [IRC Sec. 170(f)(8); Reg. §1.170A-13(f)(1)].

Be careful of reliance upon charitable contribution receipts, because their failure to provide a "detailed description of the donated goods" will invalidate them. (*Legaspi v. Comm.*, TC Summary Opinion 2015-14)

Property Donations Valued at Less Than $250

Property donations valued at less than $250 must be substantiated by (1) a written receipt or letter from the charitable organization showing the organization's name, the date and place of the contribution, and a detailed description of the property; or (2) if it is impractical to obtain a receipt, reliable written records containing the following information [Reg. §1.170A-13(b)(2)]:

1. The organization's name, the date and place of the contribution, and a detailed description of the property.

2. The FMV of the property at the time it was contributed and how FMV was calculated (if by appraisal, a signed copy should be kept).

3. The property's cost or basis (if ordinary income or short-term capital gain property).

4. The terms or conditions attached to the gift.

5. The amount of deduction claimed.

6. For securities, the issuer's name, the type of security, and whether it is regularly traded on a stock exchange or over-the-counter market.

PLANNING TIP: It is the taxpayer's responsibility to value contributed property. Resources that may be helpful include Quickfinder's *1040 Handbook* and **www.salvationarmyusa.org**.

Property Gifts of More Than $500 in Aggregate

Form 8283 (Noncash Charitable Contributions) must be attached to the return. The taxpayer must also keep written records that include the information listed above for documenting property contributions valued at less than $250.

Taxpayer must also report on Form 8283 how and when the property was acquired, and its basis or cost [Reg. §1.170A-13(b)(3)]. If the taxpayer cannot provide the cost basis or acquisition date and has reasonable cause for not doing so, an explanatory statement must be attached to the return.

TIP: Generally, if property gifted to a charity is publicly traded securities held more than one year, the taxpayer need only report how and when the securities were acquired; there is no need to show cost or adjusted basis in the securities on Form 8283.

Property Gifts of More Than $5,000

A donor who contributes property, other than publicly traded securities, valued at more than $5,000 during the tax year must obtain a qualified written appraisal and attach to his return a completed Section B of Form 8283 (Appraisal Summary) signed by the appraiser and the donee organization [IRC Sec. 170(f)(11)(C); Reg. §1.170A-13(c)].

PLANNING TIP: The person who signs the appraisal and Form 8283 must be the one who conducted the appraisal (CCA 201024065). Reg. §1.170A-13(c)(1)(i) allows no deduction if a taxpayer fails to obtain a written appraisal when it is required. Per the decision in *Hewitt*, exact compliance with the rules is required (*Hewitt v. Comm.*, 109 T.C. 258, 1997). The 2006 Pension Act expanded the definition of a *qualified appraisal* for this purpose (IRS Notice 2006-96 has more information).

COURT CASE: The $5,000 threshold is applied per item or per group of similar items (i.e., items of the same category or type, such as clothing, stamp collections, books, paintings, lithographs, non-publicly traded stock, land, or buildings). For example, a donation of five bags of clothing valued at $1,500 each would be considered a property donation of more than $5,000. See Kunkel, in which the court denied a $37,315 noncash charitable contribution that was spread between numerous charitable organizations by aggregating items and successfully claiming that they were "similar items," because in aggregate they required, but were lacking a qualified appraisal. (*Kunkel v. Comm.*, TC Memo 2015-71)

For non-publicly traded securities, a written appraisal is required only when the deduction claimed exceeds $10,000 [Reg. §1.170A-13(c)(2)(ii)].

For noncash donations over $500,000, a copy of the appraisal must be attached to the return in addition to the Form 8283 [IRC Sec. 170(f)(11)(D)]. However, this requirement does not apply to contributions of securities for which market quotations are readily available on an established securities market, inventory, intellectual property for which the deduction is limited to the lesser of basis or FMV, or vehicles if the donee sells them to an unrelated party (without significant intervening use or material improvement) and provides the donor a statement that the donor's deduction cannot exceed the proceeds shown.

COURT CASE: Taxpayer owned 50% of a real estate development partnership that donated a house to a tax-exempt organization. Taxpayer claimed a $176,255 charitable deduction which was the appraised value of the intact house. Volunteers were to disassemble and move the building materials to another location. The Tax Court disallowed the deduction since the building materials were not appraised, the appraisal attached was not a qualified appraisal and he attempted to deduct it in the wrong year. (James C. Platts, TC Memo 2018-31)

CHARITABLE PLANNING OPPORTUNITIES

Taxpayers who are age 70½ or older can make tax-free distributions to a charity from an IRA of up to $100,000 per year. These “qualified charitable distributions” aren’t subject to the charitable contribution percentage limits since they are neither included in gross income nor claimed as a deduction on the taxpayer’s return [IRC Sec. 408(d)(8)]. The SECURE Act modified this for certain taxpayers—see Chapter 16 for additional information.

PLANNING TIP: Those taxpayers looking to be charitable and take only their RMD, should make the charitable contributions early in the year.

Qualifying clients who are charitable minded, should do a direct, trustee to charity, distribution from their IRA accounts rather than take distributions and make separate charitable donations. Taking a distribution counts towards the RMD, increases AGI, which could make more of their social security taxable, and increases limitations on itemized deductions based on AGI.

Donor-advised funds are a cost-effective alternative to private foundations. They can be established with minimal start-up costs and offer immediate tax deductibility. Due to the larger standard deduction, many taxpayers will not get a full deduction for their charitable contributions starting in 2018. The public charity or community foundation receives grant requests from charities and the donor suggests which grants should be honored. The donor makes recommendations to the fund, *not* binding directives; however, donor recommendations are generally followed.

EXAMPLE: Accelerating Charitable Contributions to Increase Deduction Amount

Phil and Thropic Jones are married and file a joint return. For now into the future, they expect to have $200,000 AGI and $24,400 of itemized deductions ($10,000 state and local taxes and $14,000 charitable). Due to the increased standard deduction, the Joneses won’t receive any additional deduction for their charitable contributions. However, by accelerating their charitable giving for 3 years into one year, they can deduct $52,000 ($10,000 state and local taxes and $42,000 charitable). This creates $27,600 of additional deductions all in the current year.

SPECIAL SITUATIONS—CHARITABLE CONTRIBUTIONS

Contributions of Food Inventory

A taxpayer engaged in a trade or business is eligible to claim an enhanced deduction for donations of food inventory. [IRC Sec. 170(e)(3)(C)]. The enhanced deduction equals the lesser of (a) basis plus half of the ordinary income that would have been recognized if the property were sold at fair market value (FMV) at the contribution date, or (b) twice the property’s basis.

To qualify for the deduction, a contribution of food inventory that is apparently wholesome food—i.e., meant for human consumption and meeting certain quality and labeling standards—qualifies for the enhanced deduction.

The aggregate amount of contributions of apparently wholesome food that may be taken into account for the tax year cannot exceed 15% (increased from 10% in the PATH Act) of the taxpayer's aggregate net income from trades or businesses from which the contributions were made.

NEW LAW: For 2020 only, the CARES Act increased this threshold to 25%. As this manual went to press, the 25% threshold had not been extended.

NOTE: The purpose of this law is to encourage grocery and restaurant owners to donate wholesome food that they can or will no longer sell, because of the larger deduction than if they had thrown it away and left it in COGS. Donated apparently wholesome food can go a long way toward feeding those in need.

Deducting Out-of-Pocket Expenses as a Volunteer

Out-of-pocket expenses qualify as contributions to a charity and not for the use of the organization [Rev. Rul. 84-61], so they are subject to the 50% of AGI limitation (30% to a 30% charity). Taxpayers should maintain detailed records of expenses incurred and obtain acknowledgement from qualified organization with preceding information plus a description of the services provided.

If the total of such expenses is $250 or more for a single charitable activity, the volunteer must have a written receipt from the charity describing the taxpayer's provided services and whether the taxpayer received any goods or services (including value) from the charity in consideration [Reg. §1.170A-13(f)(10)]. However, a receipt from the charity is not required if out-of-pocket expenses are less than $250 [Prop. Reg. §1.170A-15(e)].

To be deductible, the amounts must be unreimbursed, directly connected with the services, incurred only because of the services given, and not a personal, living, or family expense [Rev. Rul. 69-473].

Car expenses are deductible at the greater of the standard mileage rate of $ .14 per mile [IRC Sec. 170(i)] or the actual cost of gas and oil that are directly related to the use in giving the service. Parking fees and tolls may be added to either method.

Travel expenses incurred while away from home performing services for a qualified organization are deductible only if the taxpayer is "on duty in a genuine and substantial sense throughout the trip" and there is no significant element of personal pleasure, recreation or vacation.

All rules apply whether paid directly (by the taxpayer) or indirectly (paid by the taxpayer to the charitable organization, which then pays the travel expenses). Deductible travel expenses include:

1. Air, rail, and bus transportation,
2. Out-of-pocket expenses for a taxpayer's car,
3. Taxi and other costs of local transportation,
4. Lodging and meal costs.

Motor Vehicles, Boats, and Airplanes

There are strict rules regarding charitable deductions exceeding $500 for these gifts; the amount of a deduction depends on how a charity uses a vehicle.

If a charity sells a qualified vehicle donated by a taxpayer without any significant intervening use of or material improvement to the vehicle, the taxpayer's charitable deduction is limited to the gross proceeds from the sale [IRC Sec. 170(f)(12)(A)(ii)].

A taxpayer may claim a deduction for the FMV of a donated qualified vehicle if the charity sells the vehicle to a needy individual at a price significantly below FMV or gives the vehicle to a needy individual, but only if the sale or gift directly furthers a charitable purpose of the charity of helping the poor, distressed, or underprivileged in need of transportation.

If a charity intends to and does significantly use a vehicle to further its charitable activities or if it makes material improvements (major repairs or improvements that significantly increase the value of a vehicle) to the donated vehicle, the taxpayer is not subject to the gross proceeds limitation, but the claimed deduction for the donation of the qualified vehicle is then limited to its FMV at the time of donation.

PLANNING TIP: A taxpayer claiming a deduction for the FMV of a qualified vehicle must be able to substantiate that value. Taxpayers may find www.kbb.com helpful.

No deduction is allowed for a charitable contribution of a qualified vehicle for which the claimed value exceeds $500 unless the contribution is substantiated with a contemporaneous written acknowledgment from the charity (Form 1098-C). An acknowledgment must also be included with the taxpayer's return on which the deduction is claimed. (IRS Pub. 4303, A Donor's Guide to Vehicle Donation, provides further information.)

Certain Gifts Are Not Deductible

The following are nondeductible gifts:

1. Gifts from which the taxpayer receives a benefit.

COURT CASE: In *Patel*, the Tax Court held on summary judgment that taxpayers who purchased property with the intent to demolish the existing house and construct a new one and granted the local fire department the right to conduct training exercises on the property and destroy the house, were not entitled to a charitable contribution deduction equal to the home's value. (*Patel v. Comm.*, 138 TC No. 23, 2012)

2. Gift of Taxpayer's Time or Services
3. Gift of a partial interest in property (restrictions apply).
4. Appraisal fees.
5. Gifts to individuals (e.g., GoFundMe contributions for medical care).

PLANNING TIP: Raffle tickets and the like are not a charitable contribution but try to explain this to our clients! They bought a chance, and the value of the chance equals the ticket price.

NEW COURT CASE: A preacher was not entitled to deduct as charitable contributions unreimbursed expenses he incurred while preaching regardless of the fact that he was a certified teacher and trainer in the Catholic Church. To be deductible the expenses must be directly connected with and solely attributable to the organization. To meet this requirement the expense must be subject to coordination, supervision, or oversight of the charitable organization. The preacher evangelized to people he happened to engage with in otherwise personal activities including friends and his extended family. No permission was obtained for the expenses. The Court disallowed over $40,000 in unreimbursed expenses for such things as flying lessons, restaurant meals, travel to visit his family, gifts and payments to individuals, airplane and automobile travel, home internet and telephone service, and office supplies finding them mostly to be personal in nature. (*Oliveri v. Comm.*, TC Memo 2019-57)

CONSERVATION EASEMENTS

Upsurge in Conservation Easement Transactions

Sen. Charles Grassley (R-IA), chairman of the Senate Finance Committee, and Sen. Ron Wyden (D-OR), the ranking member of the panel released IRS data on September 21, 2020 which they said show a "significant" increase in syndicated conservation easement transactions. "Of note, the new IRS data show that despite IRS designating them as potentially-abusive tax shelter transactions, promoters of syndicated conservation easements have continued to push the schemes," the senator said.

According to the information received from IRS, between 2017 and 2018 the number of individual participants increased from 14,000 to 16,900, with many participating in multiple deals. The total amount of deductions claimed through these tax shelters increased from $6.8 billion in 2017 to $9.2 billion in 2018. In its latest figures, IRS identified only 34 appraisers who provided valuations on some 296 syndicated conservation easement transactions, the senators said.

"Our [recent] bipartisan report detailed this exact problem and concluded that every part of the federal government needs to take further action to crack down on these schemes," Grassley said. Wyden said, "Cracking down on abusive syndicated conservation easements requires ensuring IRS has the resources and legal tools to do its job." For the Finance Committee press release, see **www.finance.senate.gov/chairmans-news/grassley-wyden-release-irs-data-showing-significant-increase-in-syndicated-conservation-easement-transactions**.

Taxpayers involved in abusive shelters should consider accepting the IRS offer to settle these cases as mentioned later in this chapter (see Chapter 3 for further discussion). Partial interests in property given to charitable organizations are usually not allowed. However, qualified conservation contributions are not subject to the partial interest rules.

PLANNING TIP: A great source of information on qualified conservation contributions is the IRS Conservation Easement Audit Techniques Guide found at **www.irs.gov/businesses/small-businesses-self-employed/audit-techniques-guides-atgs**.

A special provision allows a 100% limitation for qualified conservation contributions by qualified farmers and ranchers.

NOTE: To qualify for the 100% limitation, the donation must include a usage restriction stating that the property must remain available for agricultural or livestock production [IRC Sec. 170(b)(1)(E)(iv)].

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization to be used only for conservation purposes.

The organization also must have a commitment to protect the conservation purposes of the donation and must have the resources to enforce the restrictions.

Generally, the amount allowed as a deduction for a conservation easement is the difference between the value of the burdened property before and after the donation. It is possible that the value of a taxpayer's retained property may increase as a result of an easement. The contribution is deductible only to the extent that its value exceeds the value of benefits received (PLR 200208019).

Qualified conservation contributions are not restricted to the 30% AGI limitation, but are eligible for the 50% limitation, and 100% for qualified ranchers and farmers. Additionally, the carryover for qualified conservation contributions is 15 years, not five.

The IRS has been extremely aggressive in this area. In IRS Notice 2017-10, the IRS announced it planned to challenge conservation easement transactions which promoters are syndicating that purport to offer investors in pass-through entities charitable contribution deductions equaling or exceeding 2½ times the amount of the investment. Those transactions entered into after 2009 are now identified as "listed transactions" effective December 23, 2016. Disclosure must be made using Form 8886, Reportable Transaction Disclosure Statement. The IRS may challenge these transactions on various grounds, including overvalued easements, the partnership anti-abuse rules, economic substance, and other aspects.

RECENT DEVELOPMENT: In a June 25, 2020, press release, the IRS announced a time-limited offer to settle certain syndicated conservation easement cases pending in the Tax Court (IR 2020-130). Taxpayers eligible for the offer will be notified by letter with the applicable terms. According to the press release, the key terms of the settlement offer include—

1. The deduction for the contributed easement is disallowed in full.
2. All partners must agree to settle, and the partnership must pay, the full amount of tax, penalties, and interest before settlement.
3. "Investor" partners can deduct their cost of acquiring their partnership interests and pay a reduced penalty of 10%–20%, depending on the ratio of the deduction claimed to partnership investment.
4. "Promoter" partners (partners who provided services in connection with any syndicated conservation easement transaction) must pay the maximum penalty asserted by the IRS (typically 40%) with no deduction for costs.

Observation: The press release did not identify which penalty may be reduced for investor partners. The *40% penalty for promoters* appears to refer to the gross valuation misstatement penalty.

A donor must attach Form 8283 to his or her tax return with a statement showing the FMV of the underlying property before and after the gift and the conservation purpose furthered by the gift. The statement must set forth whether the donor made the donation in order to get a permit or approval from a governing authority and whether the donation was required by a contract. If the donor or a related person has an interest in nearby property, then the statement must describe that interest.

CASUALTY AND THEFT LOSSES

The TCJA suspended most personal casualty losses for tax years beginning after December 31, 2017, and before January 1, 2026. However, casualty and theft losses from a federally declared disaster are still deductible. (See Chapter 8 for more information.)

MISCELLANEOUS DEDUCTIONS

The TCJA suspended miscellaneous itemized deductions subject to the 2% AGI limitation for tax years beginning after December 31, 2017, and before January 1, 2026, including the following:

1. Unreimbursed employee business expenses including home office deduction.
2. Tax preparation fees, e-file costs, tax software and tax publications.
3. Expenses incurred to produce or collect income included in gross income, to manage, conserve, or maintain property held for producing such income or to determine, contest, pay or claim a refund of any tax.
4. Appraisal fees for a casualty loss or charitable contribution.
5. Clerical help and office rent in caring for investments.
6. Depreciation on a home computer if it is used to produce income (for example, a taxpayer uses the computer for tracking his investments).
7. Excess deductions allowed to a beneficiary upon termination of an estate or trust.
8. Certain legal fees, including those paid for tax advice, to collect alimony, or related to employment (e.g., amounts paid to defend a taxpayer against criminal charges arising out of his trade or business). Legal fees for drafting a will or to defend against a request for alimony are also not deductible.
9. Hobby expenses (not more than hobby income).
10. IRA or Keogh fees paid out of nonretirement funds.
11. Loss on an IRA investment.
12. Repayment of taxable Social Security benefits or unemployment compensation in an amount $3,000 or less.
13. Miscellaneous deductions from pass-through entities.

Deductions not subject to the 2% limitation referred to as Other Itemized Deductions are still permitted and include:

1. Amortizable premium on taxable bonds.
2. Casualty and theft losses from income-producing property.
3. Federal estate tax on income in respect of a decedent.
4. Fines or penalties.
5. Gambling losses up to the amount of gambling winnings.
6. Impairment-related work expenses of persons with disabilities.
7. Losses from Ponzi-type investment schemes.
8. Repayments of more than $3,000 under a claim of right.
9. Unlawful discrimination claims.
10. Unrecovered investment in an annuity.
11. An ordinary loss attributable to a contingent payment debt instrument or an inflation-indexed debt instrument (for example, a Treasury Inflation-Protected Security).

WHERE TO GO FOR MORE INFORMATION

IRS Publications available at **www.irs.gov**:

- IRS Pub. 502, *Medical and Dental Expenses (Including the Health Coverage Tax Credit)*
- IRS Pub. 526, *Charitable Contributions*
- IRS Pub. 529, *Miscellaneous Deductions*
- IRS Pub. 530, *Tax Information for Homeowners*
- IRS Pub. 550, *Investment Income and Expenses*
- IRS Pub. 561, *Determining the Value of Donated Property*
- IRS Pub. 600, *State and Local General Sales Taxes*
- IRS Pub. 936, *Home Mortgage Interest Deduction*
- IRS Pub. 1771, *Charitable Contributions Substantiation and Disclosure Requirements*
- IRS Pub. 4303, *A Donor's Guide to Vehicle Donation*
- *IRS Conservation Easement Audit Techniques Guide*

CHAPTER 8: PERSONAL CASUALTY AND THEFT LOSSES

Learning Objectives

Completion of this chapter will enable participants to—

- Determine the impact of the deduction for most personal casualty and theft losses.
- Assess a theft loss for a Ponzi-type investment scheme.
- Define a *federally declared disaster personal casualty loss* and apply the appropriate treatment.

WHAT'S NEW

1. Taxpayer Certainty and Disaster Tax Relief Act of 2020 modifications to disaster relief
2. Qualified Disaster Losses eligible for addition to the standard deduction treatment.

CASUALTY AND THEFT LOSS OVERVIEW

A *casualty* is a sudden, unexpected, or unusual event resulting in physical damage. A *sudden event* is swift—not gradual or progressive. *Unexpected events* are ordinarily both unanticipated and unintended. *Unusual events* are not a day-to-day occurrence and are atypical of the activity being carried on [Rev. Rul. 72-592 and IRS Pub. 547].

To claim a loss, a taxpayer must have a property interest or ownership. Damage must be permanent and not a temporary decline in value.

A *theft* is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the law of the state where it occurred, and it must have been done with criminal intent. There is no need to show a conviction for theft. Theft includes the taking of money or property by the following means: blackmail, burglary, embezzlement, extortion, kidnapping for ransom, larceny, and robbery.

The TCJA modified the deduction for casualty and theft loses to those attributed to a federally declared disaster for tax years 2019–2025 [IRC Sec. 165(h)(5)]. The discussion in this chapter will be limited to those losses that are eligible for deduction treatment.

NOTE: Casualty and theft losses of income-producing property, including losses from Ponzi-type investment scheme losses, are deductible as a miscellaneous itemized deduction (Line 15, Form 1040, Schedule A).

There are three types of deductible casualty losses currently allowed by law. All three types of losses refer to federally declared disasters, but the requirements for each loss vary.

IRC Sec. 165(i)(5)(A) defines a federally declared disaster as one determined by the President of the United States to warrant assistance by the Federal Government under the Robert T Stafford Disaster Relief and Emergency Assistance Act. A federally declared disaster includes a major disaster declaration or an emergency declaration under the Stafford Act.

The three types of disaster losses are:

1. Federal Casualty Losses. A *federal casualty loss* is an individual's casualty or theft loss of personal-use property that is attributable to a federally declared disaster. The casualty loss must occur in a state receiving a federal declaration. Individuals that suffer a federal casualty loss are eligible to claim a casualty loss deduction.

2. Disaster Losses. A *disaster loss* is a loss that is attributable to a federally declared disaster that occurs in an area eligible for assistance pursuant to the Presidential declaration. The disaster loss must occur in a county eligible for public or individual assistance (or both). Disaster losses are not limited to an individual's personal-use property and may be claimed for an individual's business or income-producing property. Taxpayers that suffer a disaster loss are eligible to claim a casualty loss deduction and to elect to claim the disaster loss in the preceding tax year.

3. Qualified Disaster Losses. A *qualified disaster loss* is an individual's casualty or theft loss of personal-use property that is attributable to a major disaster declared by the President under section 401 of the Stafford Act in 2016 or other named storm law relief. Individuals that suffered a qualified disaster loss are eligible to claim a casualty loss deduction, to elect to claim the loss in the preceding tax year, and to deduct the loss without itemizing other deductions on Schedule A (Form 1040 or 1040-SR).

Casualty losses other than qualified disaster losses are subject to two limitations:

1. The $100 per-casualty floor. First, the loss is allowed only to the extent the amount of the loss from each casualty, or from each theft, exceeds $100. [IRC Sec. 165(h)(1)] and

2. The 10%-of-AGI limitation. If personal casualty losses for a tax year exceed personal casualty gains for that tax year, then the losses are allowed only to the extent of the sum of (1) the amount of the personal casualty gains for the tax year, plus (2) so much of the excess as exceeds 10% of the taxpayer's adjusted gross income . [IRC Sec. 165(h)(2)(A)]

In computing the 10%-of-AGI limitation, the amount of any personal casualty loss is determined after application of the $100 per-casualty floor. [IRC Sec. 165(h)(3)(B)]

Qualified Disasters losses as modified by Disaster Act of 2019 and Taxpayer Certainty Tax Relief Act of 2020 (see below) are accorded the following treatment:

1. Itemized Deduction. The per-casualty floor for qualified disaster-related personal casualty losses is $500. [TCDTR §304(b)(1)(B)]. The 10%-of-AGI limitation doesn't apply to the net disaster loss,or

2. Additional Standard Deduction. Treat the net disaster loss as an addition to the individual's standard deduction, rather than as an itemized deduction.

To determine areas designated as federal disaster areas please visit **www.fema.gov/disasters**.

Casualty Gains

A special rule allows a deduction for a personal casualty loss not attributable to a federally declared disaster to the extent the loss does not exceed personal casualty gains [IRC Sec. 165(h)(5)(B)].

A *personal casualty gain* is the recognized gain from any involuntary conversion of nonbusiness, not-for-profit property, arising from a casualty or theft, where a taxpayer receives an insurance payment or other reimbursement exceeding their adjusted basis in the property.

A taxpayer may deduct the portion of a personal casualty loss not attributable to a federally declared disaster (a non-federal casualty loss) to the extent the loss doesn't exceed personal casualty gains [IRC Sec. 165(h)(5)(B)(i)].

In applying the 10%-of-AGI floor to federally declared disaster losses, the amount of an individual's personal casualty gains for a tax year available to offset against federally declared disaster losses is reduced by the amount of personal casualty gains for the year offset against non-federal casualty losses [IRC Sec. 165(h)(5)(B)(ii)].

PLANNING TIP: Where an individual has both personal casualty gains and personal casualty losses for a tax year, the individual first reduces the amount of personal casualty gains by the amount of non-federal casualty losses. Any remaining personal casualty gains are then used to reduce the amount of the taxpayer's deductible federally declared disaster losses. Any remaining federal disaster losses are deductible to the extent they exceed 10% of AGI.

EXAMPLE: Treatment of personal casualty losses

Xavier has AGI of $100,000 for the current tax year and suffers a qualifying personal casualty loss in October 2020. After applying the $100-per-casualty limit, he also has $20,000 of non-federal casualty losses, $30,000 of federally declared disaster losses, and $25,000 of personal casualty gains for the year. The non-federal casualty losses are offset against personal casualty gains and reduce the amount of personal casualty gains to be applied against Xavier's federally declared disaster losses of $30,000 in the amount of $5,000 ($25,000 − $20,000).

Xavier may deduct $5,000 of federally declared disaster losses to offset the remaining personal casualty gains. He then applies the 10%-of-AGI limit (10% × $100,000 AGI = $10,000). Of his remaining $25,000 in disaster losses, Xavier may deduct $15,000 ($25,000 – $10,000).

RECENT LAW CHANGES

The Disaster Act of 2019 (the Act)

1. Provides any individual with a principal place of abode or any taxpayer with a principal place of business in a disaster area an automatic 60-day extension with regard to any tax filing. This applies to federally declared disasters declared after December 20, 2019.

2. Special rules for qualified disaster-related personal casualty losses. With respect to uncompensated losses arising in a disaster area, the Act eliminates the current law requirements that personal casualty losses must exceed 10% of adjusted gross income to qualify for deduction. The Act also eliminates the current law requirement that taxpayers must itemize deductions to access this tax relief.

3. Other relief including exception to 10% premature retirement plan distributions, special earned income elections for 2018 and the additional standard deduction for qualified disaster losses.

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTR), part of the Consolidated Appropriations Act, 2021 provides special rules for individuals who have a net disaster loss for any tax year. (TCDTR Sec. 304(b))

"Net disaster loss" means the excess of qualified disaster-related personal casualty losses over personal casualty gains (as defined in IRC Sec. 165(h)(3)(A)). (TCDTR Sec. 304(b)(2))

"Qualified disaster-related personal casualty losses" means personal casualty losses that arise in a qualified disaster area on or after the first day of the incident period of the qualified disaster to which the area relates, and that are attributable to the qualified disaster. (TCDTR Sec. 304(b)(3))

The TCDTR increases the per-casualty floor for qualified disaster-related personal casualty losses from $100 to $500. (TCDTR Sec. 304(b)(1)(B))

Under the TCDTR, the 10%-of-AGI limitation doesn't apply to the net disaster loss. The 10%-of-AGI limitation applies only to the excess of the taxpayer's personal casualty losses over personal casualty gains reduced by the net disaster loss amount. (TCDTR Sec. 304(b)(1)(A))

The TCDTR treats the net disaster loss as an addition to the individual's standard deduction, rather than as an itemized deduction. (TCDTR Sec. 304(b)(1)(C)) Although the standard deduction is disallowed for alternative minimum tax purposes, that disallowance does not apply to the increased amount attributable to the net disaster loss. (TCDTR Sec. 304(b)(1)(D))

RECENT DEVELOPMENT: Program Manager Technical Advice (PMTA) 2019-008 addresses the effective date and scope of the new personal casualty loss limitation. The PTMA provides two examples of how new IRC Sec. 165(h)(5) works to limit individual casualty losses.

In the first example, Art’s home in Kansas was damaged in 2017 by a flood that was not a federally declared disaster. Art filed a claim with his insurance for the entire loss and had a reasonable prospect of recovering the entire amount claimed. In 2018, Art received 70% of the claimed amount from his insurance and it became reasonably certain that Art would not recover the other 30% of his claim. Thus, in 2018, Art sustained an individual casualty loss equal to 30% of the total flood damage that occurred in 2017. However, Art’s individual casualty loss was not deductible under IRC Sec. 165(h)(5) because it was not attributable to a Federally declared disaster and was sustained in 2018.

In the second example, assume Art’s flood damage in 2017 occurred during a storm for which the president issued a Federal disaster declaration for Kansas under the Stafford Act. However, Art's home was not located in one of the counties designated as eligible for assistance.

According to PMTA 2019-008, Art could claim an individual casualty loss deduction, even though his home was not in one of the designated counties, because IRC Sec. 165(h)(5) does not require the loss to occur in a disaster area; it only requires the loss to be attributable to a federally declared disaster. Therefore, as long as Art's home was in a state that received a Federal disaster declaration and his loss was attributable to that disaster, Art was eligible to claim an individual casualty loss deduction in 2018 for the 30% he did not recover from his insurance claim.

POSTPONED TAX DEADLINES

The IRS may postpone for up to 1-year certain tax deadlines of taxpayers who are affected by a federally declared disaster. The tax deadlines the IRS may postpone include those for filing income, excise, and employment tax returns; paying income, excise, and employment taxes; and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publicize the postponement in the respective area(s) and publish a news release and, where necessary, record it in a Revenue Ruling, Revenue Procedure, Notice, Announcement, or other guidance in the Internal Revenue Bulletin (IRB). Visit **irs.gov/ disastertaxrelief** to find out if a tax deadline has been postponed for specific areas.

ELECTION TO TREAT THE CASUALTY LOSS IN THE PRECEDING YEAR

A taxpayer may elect to take a federally declared disaster loss on the income tax return for the immediately preceding year [IRC Sec. 165(i)(1)]. If an election is made, the casualty resulting in the loss is treated as having occurred during the taxable year that the deduction is claimed [IRC Sec. 165(i)(2)]. Reg. 1.165-11 addresses elections and revocations made on or after October 16, 2019. An election under IRC Sec. 165(i) to deduct a disaster loss for the preceding year is made either on an original Federal income tax return for the preceding year or an amended Federal income tax return for the preceding year [Reg. §1.165-11(h)].

The due date for making the Section 165(i) election is six months after the due date for filing the taxpayer's Federal income tax return for the disaster year (determined without regard to any extension of time to file). The taxpayer need not request an extension of time to file the federal tax return for the disaster year in order to benefit from the due date identified in the regulations.

The Section 165(i) election may be revoked on or before the date that is 90 days after the due date for making the election. An election should contain the name or a description of the disaster, the date(s) the disaster took place, and the city, town, county, parish, state and zip code where the damaged or destroyed property was located [Rev. Proc. 2016-53, Section 3.02].

CAUTION: For the loss to be considered in the taxable year immediately preceding the taxable year in which the disaster occurred, the loss must both occur in a disaster area and be attributable to a federally declared disaster [IRC Sec. 165(i)(1)].

Things to consider when choosing which year to take a disaster loss:

1. A taxpayer's need for cash.
2. Tax bracket and taxable income for each year.
3. AGI in both tax years, due to the Section 165(h)(2) limitations.

Taxpayers with homes located in a disaster area may deduct losses attributable to that disaster as a disaster loss so long as they meet the following requirements:

1. The taxpayer must be ordered by the state or local government to demolish or relocate the residence [IRC Sec. 165(k)(1)] by the 120th day after the date the disaster is named a federally declared disaster [IRC Sec. 165(k)(1)], and

2. The residence must have been rendered unsafe for use as a residence because of the disaster [IRC Sec. 165(k)(2)].

Insurance reimbursements for living expenses following the occurrence of a casualty to a taxpayer's principal residence are accounted for independently of the casualty loss computation.

1. The taxpayer must report as taxable income any insurance reimbursements that cover normal living expenses.

2. Payments that cover increased temporary living expenses are not taxable income [IRC Sec. 123; Reg. §1.123-1].

AMOUNT OF DEDUCTION

A deduction under IRC Sec. 165(a) is limited, in the case of losses of an individual, to the following:

1. Losses incurred in a trade or business [IRC Sec. 165(c)(1)],

2. Losses incurred in any transaction entered for profit, though not connected with a trade or business [IRC Sec. 165(c)(2)], and

3. Losses of property not connected with a trade or business or a transaction entered for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or other theft [IRC Sec. 165(c)(3)].

The basis for determining a deduction for any loss is the adjusted basis of the property for determining a loss from a sale or other disposition [IRC Sec. 165(b)].

A loss is the decrease in the FMV before and after a casualty but cannot exceed the adjusted basis of the property [Reg. §1.165-7(b)(1)].

Reg. §1.165-7(a)(2) provides two methods of valuing a casualty loss:

1. **Decrease in FMV Method.** To be eligible based on a decrease in FMV, a taxpayer must prove the FMV of the property immediately before and immediately after the casualty, ascertained by competent appraisal. An appraisal must recognize effects of any general market decline affecting undamaged as well as damaged property that may occur simultaneously with the casualty [Reg. §1.165-7(a)(2)(i)].

CAUTION: Numerous court cases emphasize the importance of obtaining evidence of the adjusted basis and FMV of property immediately before and immediately after a casualty loss. One landmark case is *Zmuda v. Comm.* [79 T.C. 714, aff'd, 731 F.2d 1417 (9th Cir. 1984)]. (Also see *Cole v. Comm.*, TC Summary Opinion 2013-34.)

2. **Cost of Repairs Method.** The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that [Reg. §1.165-7(a)(2)(ii)]—

    a. repairs are necessary to restore the property to its condition immediately before the casualty,

    b. the amount spent for such repairs is not excessive,

c. the repairs do not care for more than the damage suffered, and

d. the value of the property after the repairs does not, as a result of the repairs, exceed the value of the property immediately before the casualty.

CAUTION: Repairs must be made. Taxpayers have been struck down when estimates, rather than the actual cost of repairs, have been used in claiming a deduction [*Clapp v. Comm.*, 36 TC 905, 908 (1961), aft. 321 F.2d 12 (9th Cir. 1963); and *Robin E. Schmidt v. Comm.*, TC Summary Opinion 2002-23].

PLANNING TIP: See Rev. Proc(s). 2018-8 and 2018-9, which provide several optional safe harbors for determining amount of casualty loss deductions for personal residential property and personal belongings that occur due to natural disasters.

Rev. Proc. 2018-8 provides five safe harbors for casualty losses on personal-use residences. The estimated repair cost safe harbor method (casualty losses of $20,000 or less), the de minimis safe harbor method (casualty losses of $5,000 or less) and the insurance safe harbor method are available for individuals who suffer casualty losses under IRC Sec. 165. The contractor safe harbor method and disaster loan appraisal safe harbor method are only available for home damage due to a federally declared disaster. For personal belongings, there is a de minimis safe harbor method (casualty or theft losses under $5,000). The replacement cost safe harbor method for personal belongings losses after a federally declared disaster is also available.

Rev. Proc. 2018-9 provides a safe harbor method under which individuals may use one or more cost indexes to determine the amount of the loss to their homes as a result of Hurricane and Tropical Storm Harvey, Hurricane Irma, and Hurricane Maria.

TIMING OF DEDUCTION

Generally, a Section 165(a) loss is allowed only for the taxable year when it is sustained. However, federally declared disaster losses may be claimed in the tax year preceding the disaster.

If a casualty loss occurs and there is a claim for reimbursement with a reasonable prospect of recovery, no portion of the loss, up to the expected reimbursement, is deductible until there is reasonable certainty whether the reimbursement will be received [Reg. §1.165-1(d)(2)(i)]:

1. Any portion not covered by insurance is allowed during the taxable year when the casualty or theft took place [Reg. §1.165-1(d)(2)(ii)].

2. When a taxpayer deducts a loss and in a subsequent taxable year receives a reimbursement, it is included in income for the taxable year when received, subject to the tax benefit rule [Reg. §1.165-1(d)(2)(iii)].

3. If an eventual reimbursement turns out to be less than originally expected, a loss may be claimed in the year it is determined the taxpayer cannot reasonably expect any further reimbursement.

4. Do not amend the original return [Reg. §1.165-1(d)(2)(ii)]. An additional loss is treated as if sustained in the year of settlement.

INSURANCE CONSIDERATIONS

Casualty and theft losses of an individual, to the extent covered by insurance, shall be allowed only if the individual files a timely insurance claim with respect to such loss [IRC Sec. 165(h)(4)(E)]. Casualty losses are not allowed to the extent they are reimbursable. If the reimbursement exceeds the tentative loss, the taxpayer may have taxable income. The insurance proceeds received, or receivable must be accounted for, whether they reduce the loss or are includable in taxable income [Reg. §1.165-1(d)(2)(ii)].

EXAMPLE: Treatment of insurance reimbursement of casualty loss

Jesse's home is destroyed in a late-2020 federally declared disaster. The loss was $550,000 (he bought it for $600,000). Jesse files an insurance claim and reasonably expects to receive reimbursement for the entire loss. Therefore, he does not have a casualty loss during the year. The claim is rejected by the insurance company. He files a lawsuit and during the following year, he and the insurance company agree on a settlement of $450,000. The $100,000 casualty loss is claimed on his return in the year of settlement, subject to the $100 and 10%-of-AGI limitations. Because the fire started as a result of a federally declared disaster and his home is located in the disaster area, he has the option of amending his prior year return.

A taxpayer may be surprised to find a taxable gain to report due to an insurance reimbursement or other relief. For non-disaster area casualties, insurance proceeds from property losses are gains to the extent they exceed the adjusted basis of the property. The gain realized must be recognized as income for tax purposes unless the taxpayer elects to defer recognition under IRC Sec. 1033 or meets a Section 121 exception.

The replacement period under IRC Sec. 1033 is generally two years after the close of the first tax year in which any gain is recognized. However, a four-year replacement period is available for a principal residence or any of its contents located in a federally declared disaster area.

EXAMPLE: Determining taxable gain on insurance reimbursement for a casualty loss

Charli's home is destroyed in a hurricane (federally declared disaster). The loss was $550,000, but she only paid $80,000 when she originally purchased it. Charli, a single taxpayer, receives a check from her insurance company for the entire amount. She decides not to rebuild and makes no Section 1033 election. Charli has a taxable long-term capital gain of $220,000, calculated as follows:

Insurance proceeds	$ 550,000
Basis	(80,000)
Realized gain	470,000
Gain exclusion (IRC Sec. 121)	(250,000)
Long-term capital gain	$ 220,000

THEFT LOSS DEDUCTION FOR PONZI-TYPE INVESTMENT SCHEME

Subsequent to Bernie Madoff's guilty plea in 2009, the IRS issued generous, pro-taxpayer guidance for investors caught in his and other Ponzi-type scheme frauds:

1. Rev. Rul. 2009-9 treats Ponzi-type scheme losses as ordinary losses not subject to the 10% floor.

2. Rev. Proc. 2009-20 gives a qualified investor a safe harbor to deduct a loss in the year of discovery, notwithstanding the timing of deduction rules:

    a. The deduction is 95% of the qualified loss if the investor is only pursuing those who perpetrated the fraud.

    b. The deduction is 75% of the qualified loss if the investor is pursuing third parties connected with the fraud.

    c. The taxpayer should put “Revenue Procedure 2009-20” at the top of Form 4684 (Casualties and Thefts) and sign and attach the statement found in Appendix A of the Revenue Procedure.

3. Rev. Proc. 2011-58 modifies Rev. Proc. 2009-20 to address certain situations in which a lead figure dies, and criminal charges cannot be brought. The discovery year is the tax year during which the indictment, information, or complaint is filed, or the lead figure’s death occurs, whichever is later.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 976, *Disaster Relief*
- IRS Pub. 547, *Casualties, Disasters, and Thefts*
- IRS Pub. 584, *Casualty, Disaster and Theft Loss Workbook (Personal-Use Property)*
- Tax Relief in Disaster Situations at **www.irs.gov/newsroom/tax-relief-in-disaster-situations**

CHAPTER 9: HOUSEHOLD EMPLOYEES AND PAYROLL

Learning Objectives

Completion of this chapter will enable participants to—

- Describe how to properly report payments to household or domestic workers.
- Assist clients with the household employee determination.

WHAT'S NEW

- Expanded discussion of home health workers
- Review of the ability to provide room and board to home health workers

OVERVIEW

A worker hired to do household work is an employee if the taxpayer can control not only what work is done, but how it is done.

Workers obtained from an agency aren't a taxpayer's employees if the agency is responsible for who does the work and how it is done. Self-employed workers are also not employees. A worker is self-employed if only he can control how the work is done. A self-employed worker usually provides his own tools and offers services to the general public in an independent business. Certain licensed health care professionals are also deemed to be self-employed workers.

If the worker is an employee, it doesn't matter whether the work is full-time or part-time or that the taxpayer hired the worker through an agency or from a list provided by an agency or association. It also doesn't matter whether the taxpayer pays the worker on an hourly, daily, or weekly basis, or by the job.

Household employees are frequently misclassified as self-employed. The failure to treat a household employee correctly can create numerous tax issues. A non-exclusive list of household employees can include housekeepers, maids, babysitters, gardeners, home healthcare and others who work in or around your private residence as your employee. Those workers who are mis-classified as self-employed are often discovered when the worker files a state unemployment claim causing numerous problems for the household employer.

EXAMPLE: Determining who is a household employee

Scenario 1: Rose, a self-employed gardener, agrees to mow lawns, trim shrubs, and provide general yard work. She schedules the time for providing these services. She supplies the necessary tools and workers needed to do the job. Under these circumstances, Rose is an independent contractor, *not* an employee.

Scenario 2: Mortimer Snurd pays cash wages and furnishes meals on premises to Betty Shore for her babysitting and light housekeeping services four days a week in his home. Betty follows Mortimer's specific instructions about household and child care duties. Mortimer provides the household equipment and supplies that Betty needs to do her work. Betty is Mortimer's household employee.

Scenario 3: Maribeth's mother Sandy can no longer perform daily living functions of personal care, household care, or personal health care and needs emotional support. Sandy's doctor has indicated that she is no longer capable of self-care, so Maribeth hires Helen Ready to assist Sandy. Helen is provided with a salary, room, and board. Helen is a household employee; thus, her cash wages are subject to the rules of household employees. If certain conditions are met, the cost/value of the room and board are not taxable to Helen. Also, the costs would be treated as medical expenses since they are performed for Sandy, who is critically ill, have been prescribed by Sandy's physician, and are part of a program of maintenance and personal care expenses.

PLANNING TIP: If an individual employs private-duty nurses or attendants as an alternative to moving to a nursing home or other long-term care facility. The costs of these in-home services are deductible as a medical expense if they qualify as either medical care or long-term care services [IRC Sec. 213(d)(1)].

Many home health care providers qualify as household employees and are subject to employment taxes [Rev. Ruls. 61-196, 68-398 and 74-388]. However, licensed health practitioners are generally considered self-employed individuals and not household employees because their services usually consist primarily of medical assistance and not domestic services [Rev. Rul. 61-196].

Also, if a household employee cares for the taxpayer's dependent who is under age 13 or for his spouse or dependent who isn't capable of self-care, he may be able to claim the credit for child and dependent care expenses.

U.S. CITIZENSHIP AND IMMIGRATION SERVICES (FORM I-9)

It is unlawful to knowingly hire or continue to employ an alien who cannot legally work in the United States. The employer and employee must complete the U.S. Citizenship and Immigration Services (USCIS) Form I-9, Employment Eligibility Verification.

No later than the first day of work, the employee must complete the employee section of the form by providing certain required information and attesting to his current work eligibility status in the United States.

An employer must complete the employer section by examining documents presented by the employee as evidence of his identity and employment eligibility. Acceptable documents to establish identity and employment eligibility are listed on Form I-9 (e.g., U.S. passport, permanent resident card).

The employer must keep the completed Form I-9 in their records as it must be available for review upon notice by an authorized U.S. Government official. Assistance for this process can be found at **www.uscis.gov/i-9-central/complete-and-correct-form-i-9**.

WORKERS COMPENSATION INSURANCE

The state workers compensation (WC) insurance requirements are often overlooked. Failure to cover a worker can subject an employer to civil liability (i.e., the court will determine the financial liability). Thresholds for coverage vary. (Hawaii requires coverage starting at $225 per quarter, Kansas does not require coverage until employment reaches $20,000 annually). Detail of state mandated coverage can be found at **https://gtm.com/household/resource-center/workers-comp-requirements**.

PAYROLL TAX ISSUES

A taxpayer with a household employee may need to withhold and pay social security and Medicare taxes, pay federal unemployment tax, or both.

An employer must withhold and pay social security and Medicare taxes (FICA) if he pays cash wages of $2,300 (or more) during 2021 to any one household employee (see the exceptions later in this chapter). FICA taxes are 15.3% of cash wages. The employee portion is 7.65% and the employer match share is 7.65%. The threshold applies separately to each employee.

When cash wages reach $2,300 during a calendar year, all prior amounts paid that calendar year become subject to FICA taxes (Notice 95-18).

PLANNING TIP: An employer may prefer to pay the employee's portion of social security and Medicare taxes from their own funds, rather than withholding them from the employee's wages. The social security and Medicare taxes paid to cover an employee's share must be included in the employee's wages for income tax purposes. However, they aren't counted as social security and Medicare wages or as federal unemployment (FUTA) wages.

EXAMPLE: Determining amount of withholding

In 2021, Juan hires a household employee (who is an unrelated individual over age 18) to care for his child and agrees to pay cash wages of $100 weekly.

Juan expects to pay his employee $2,300 or more for the year. He decides to pay the employee's share of social security and Medicare taxes from his own funds. Juan pays his employee $100 every Friday without withholding any social security or Medicare taxes.

For social security and Medicare tax purposes, the employee's wages each payday are $100. For each wage payment, Juan will pay $15.30 when he pays the taxes. This is $7.65 ($6.20 for social security tax plus $1.45 for Medicare tax) to cover the employee's share plus $7.65 for the employer's matching share.

For income tax purposes, the employee's wages each payday are $107.65 ($100.00 plus the $7.65 Juan will pay to cover the employee's share of social security and Medicare taxes).

An employer must pay federal unemployment tax (FUTA) if he pays total cash wages of $1,000 or more in any calendar quarter of 2020 or 2021 to household employees. FUTA must be paid on the first $7,000 paid to each household employee during 2021, even for those who may not be subject to FICA. The nominal rate is 6%, against which a credit of up to 5.4% applies, depending upon the state.

Cash wages include wages paid by check, money order, etc. Cash wages don't include the value of food, lodging, clothing, transit passes, and other noncash items provided the household employee. However, cash given the employee in place of these items is included in cash wages.

1. Noncash wages paid to household employees aren't subject to social security taxes or Medicare taxes; however, they are subject to federal income tax unless a specific exclusion applies.

2. An employer must report the value of taxable non-cash wages in Box 1 of Form W-2 together with cash wages (but do not include noncash wages in Boxes 3 or 5 of Form W-2).

3. Room and board furnished as a condition of employment can be excluded from Box 1. (See discussion later in this chapter.)

Household wages are exempt from the FICA and FUTA tax if paid to—

1. The taxpayer's spouse.

2. The taxpayer's child under the age of 21.

3. The taxpayer's parent, unless both of the following conditions apply:

    a. The parent cares for the taxpayer's child who either is under the age of 18, or has a physical or mental condition that requires the personal care of an adult for at least four continuous weeks in the calendar quarter services were performed, and

    b. The taxpayer's marital status is divorced and not remarried, widow or widower, or the taxpayer is living with a spouse whose physical or mental condition prevents him from caring for the taxpayer's child for at least four continuous weeks in the calendar quarter services were performed.

PLANNING TIP: While wages paid to a taxpayer's parent may be subject to FICA if both of the previous conditions are met, wages paid to a taxpayer's parent *are not* subject to FUTA.

4. An employee who is under the age of 18 at any time during the year. However, the wages must be counted if providing household services is the employee's principal occupation. If the employee is a student, providing household services isn't considered to be his principal occupation.

CAUTION: While wages paid to an employee who is under age 18 are not subject to FICA, such wages paid may be subject to FUTA.

An employer who does not withhold FICA taxes from an employee is generally liable for the full amount of the federal employment taxes that should have been withheld and/or paid. Certain penalties (e.g., failure to timely file Form W-2) may also apply.

Taxpayers may also have state and/or local reporting requirements.

An employer is not required to withhold federal income tax from a household employee's wages. An employer may withhold federal income tax if the employee has requested withholding and the employer agrees to do so, in which case, the employee must provide the employer with a completed Form W-4.

Household employers must attach Schedule H to Form 1040. Schedule H (Household Employment Taxes) is used to figure employer's total household employment taxes (social security, Medicare, FUTA, and withheld federal income taxes). The household employment taxes are added to the taxpayer's personal income tax. The 2021 amount is due by April 15, 2022.

Sole proprietors with both business and household employees should include social security, Medicare, and withheld federal income taxes for household employees on a Form 941 or a Form 944 filed for the sole proprietorship, or on a Form 943 filed for a Schedule F (farm) activity. In this case, FUTA tax is reported on Form 940.

In most states, household employers are required to register as part of the state's unemployment tax system. Anecdotally, with more parents working from home, greater numbers of terminated household employees filed for unemployment benefits.

PROVIDING ROOM AND BOARD TO HOUSEHOLD EMPLOYEES

IRC Sec. 119(a) allows the exclusion from income the value of meals and lodging furnished by the employer for a live-in worker provided the following conditions are met:

- Meals and lodging (room and board) must be furnished on the business premises (the family's home),
- Meals and lodging must be furnished for the employer's convenience (e.g., the worker cannot leave the home for lunch when on duty), and
- For lodging only, employees must be required to accept the lodging as a condition of employment.

It should be noted that meals may be furnished to a worker who does not live in the home but is required to stay on premises for meals, such as may be the case for a nanny or a healthcare assistance worker.

2020/2021 PANDEMIC ECONOMIC SUPPORT INITIATIVES

Congress has provided a multitude of tax and financing (e.g., the Paycheck Protection Program) provisions in the wake of the COVID-19 pandemic to provide economic support to individuals and small businesses.

Employers whose domestic service workers are economically dependent on their household employment must generally pay required sick and/or expanded family and medical leave to eligible workers. For example, a domestic service worker who cares for a taxpayer's children as a full-time job, follows an employer's precise directions while working, and has no other clients, is likely economically dependent on their household employment (see DOL FAQ 89).

TIP: Employers may offset the cost of the required paid leave (along with allocable qualified health plan expenses and the employer portion of Medicare tax) by claiming tax credits on Form 941 (as applicable) or by reducing the employer's 2020 or 2021 Form 1040-ES estimated tax liabilities by the total credits claimed. (See Chapter 6 for further discussion of the paid leave credits.)

In published FAQs on the employee retention credit, the IRS has clarified that household employers are not considered to operate a trade or business and, therefore, are not eligible for the employee retention credit with respect to their household employees.

An SBA Interim Final Rule (published on April 15, 2020) confirmed that a household employer (e.g., an individual who employs household employees such as nannies or housekeepers) is not an eligible employer and is, therefore, ineligible for a PPP loan.

PLANNING TIP: The 2020/2021 pandemic acts and the economic support provided by Congress in its wake (e.g., unemployment, required paid leave) make proper and accurate reporting of compensation paid to household employees crucial.

WHERE TO GO FOR MORE INFORMATION

- IRS Topic No. 756, Employment Taxes for Household Employees
- IRS Pub. 926, *Household Employer's Tax Guide*
- Instructions for Schedule H (Form 1040), Household Employment Taxes
- Department of Labor's Families First Coronavirus Response Act FAQs at **www.dol.gov/agencies/whd/pandemic/ffcra-questions**
- Family Caregiver Alliance: **www.caregiver.org/resource/hiring-home-help**

CHAPTER 10: FILING STATUS AND DEPENDENTS

Learning Objectives

Completion of this course will enable participants to—

- Identify the correct filing status for a taxpayer.
- Describe the rules for head of household filing status eligibility.
- Recognize and explain the dependency rules.

WHAT'S NEW

- Expanded discussion of common law marriages.
- Expanded discussion of married filing jointly versus married filing separately.
- Signatures by spouses of a MFJ return.

FILING STATUS

The five filing statuses are Single, Married Filing Jointly (MFJ), Married Filing Separately (MFS), Head of Household (HOH), and Qualifying Widow(er) with Dependent Child.

Filing status is based on numerous factors including a taxpayer's marital status, dependents and living arrangements. The filing requirement, taxation of income (social security), availability of deductions, standard deduction amounts, and tax tables are all affected by the filing status.

Optimizing filing status for taxpayers with dependents living outside of traditional relationships or households is often complex. In multi-generational households, potentially multiple members of the household may be entitled to claim dependents that qualify for Head of Household (HOH) status, child tax credits and the earn income credit all of which are subject to due diligence penalties for the unwary practitioner.

Filing status is determined on the last day of the year. For example, if a taxpayer is single on December 31st, the taxpayer has a single filing status for the entire year. However, an exception applies for widow(er)s.

GENERAL FILING STATUS CONSIDERATIONS

Unmarried Persons

A taxpayer is considered unmarried for the whole year if, on the last day of the tax year, he/she is unmarried or is legally separated (according to the laws of the state of residence) from the spouse under a divorce or separate maintenance decree. (See Chapter 11 for more information.)

Taxpayers are considered *married for the whole year* if on the last day of the tax year, both spouses meet any one of the following tests:

1. They are married and living together.

2. They are living together in a common law marriage that is recognized in their state of residence.

NOTE: Eight states currently recognize common law marriage; however, the states differ on their thresholds of recognizing the status of common law marriage (**www.ncsl.org/research/human-services/common-law-marriage.aspx**).

Six states previously recognized common law marriage but no longer do. If the qualifications for the common law marriage statute were met prior to abolishment of the statute, the marriage will continue to be recognized.

3. They are married and living apart, but not legally separated under a decree of divorce or separate maintenance.
4. They are separated under an interlocutory (not final) decree of divorce. For purposes of filing a joint return, they are not considered divorced.

In the year of death, the surviving spouse, unless remarried, is married for the entire year and can file a joint return with the deceased spouse, if the executor gives approval. The rule also applies if both spouses die [Reg. §1.6013-1(d)]. (See Chapter 42 for more information.)

PLANNING TIP: If taxpayers obtain a court decree of annulment, which holds that no valid marriage ever existed, they are considered unmarried even if they filed joint returns for earlier years. The taxpayer must file amended returns (Form 1040X) claiming single or head of household status (as applicable) for all tax years that are affected by the annulment, that are not closed by the statute of limitations for filing a tax return.

Marriage Penalty

The marriage penalty is the additional tax married individuals pay over the tax they would have paid had they remained single. The TCJA provided some tax rate relief. Under prior law, the married filing joint tax rate schedule was twice the single rate schedule up to the 15% tax bracket. The TCJA aligned the MFJ and the single tax rates up to the end of 32% bracket. MFS rates are one-half the joint tax rates.

The 2021 TCJA rate (ordinary) bracket thresholds are as follows:

2021 Tax Rates – Thomson Reuters

Rate	Joint/Surviving Spouse		Single		Head of Household	
	Begins	**Ends**	**Begins**	**Ends**	**Begins**	**Ends**
10%	$0	$19, 900	$0	$9,950	$0	$14,200
12%	$19,901	$81,050	$9,951	$40,525	$14,201	$54,200
22%	$81,051	$172,750	$40,526	$86,375	$54,501	$86,350
24%	$172,751	$329,850	$86,376	$164,925	$86,351	$164,900
32%	$329,851	$418,850	$164,926	$209,425	$164,901	$209,400
35%	$418,851	$628,300	$209,426	$523,600	$209,401	$523,600
37%	$628,301		$523,601		$523,601	

NOTE: Married Filing Separate rates are ½ Married Filing Joint rates.

The marriage penalty persists because:

1. It is easier for a household of two unmarried individuals to structure their affairs to maximize deductions. Two single individuals can deduct twice the amount of mortgage interest and state and local taxes than their married counterparts, since the mortgage interest indebtedness limit and state and local taxes (SALT) limitations are the same for both single and married taxpayers—currently, $750,000 and $10,000 (see U.S. Court of Appeals, 12-73257 and 12-73261, the *Voss* and *Sophy* cases, which found two separate limits for unmarried individuals living in the same home).

2. A household of two unmarried individuals with one principal income earner can still receive credits and special filing status that would be phased out or unavailable if they were married. Households comprised of unmarried taxpayers with children can potentially claim head of household status. Further, it is not unusual for the lower earning spouse claiming the child to receive the earned income credit.

CAUTION: MFS returns will not get around the SALT limitation or the mortgage interest cap. The aggregate limit is $10,000 for all taxpayers except MFS filers for whom the limit is $5,000. The mortgage interest cap for those filing married filing separate returns is limited to $375,000 starting in 2018.

Joint versus Married Filing Separate Returns

Married taxpayers have the option of filing joint or separate returns unless either of the following exceptions apply which requires the filing of separate returns:

1. Either spouse is a nonresident alien at any time during the year (unless the nonresident spouse elects to be treated as a resident alien, which causes the nonresident spouse's worldwide income to be subject to U.S. tax); or

2. They have different tax year-ends (unless the different years are due solely to death) [IRC Sec. 6013(a)].

While generally the filing of a joint return is preferable, the filing of separate returns should be considered for both tax and non-tax issues.

Tax Issues:

- If there are uncertainties of filing status always file MFS as that status can be changed after the return due date, see details later in this chapter.

- Taxpayers have significant income or deductions that are affected by AGI such as social security income, or medical deductions. Filing a separate return may be preferable where the qualified business income deduction is subject to a phaseout.

OBSERVATION: As a result of ARPA 2021, an unemployment income exemption was provided for taxpayers, without regard to filing status, for those who had modified AGI less than $150,000. While the UEC exemption was unusual, that event reinforced why it is critical to annually review the decision of filing status for married taxpayers. As noted later in this chapter, a MFJ status cannot be modified to a MFS after the extended due date of the return.

Non-Tax Issues:

- Pending divorce or separation issues.
- The taxpayers are unable to pay the joint tax liability. Filing a joint return exposes both spouses to the IRS's collection claims (joint and several liability), except to the extent that innocent spousal relief is available. Filing separate returns may protect a taxpayer's income and other property if their spouse is responsible for the tax liability.
- Other non-tax factors such as a spouse's questionable business practices, reluctance to recognize income, or an aggressive tax position could expose the taxpayer to additional liability.

COURT CASES: A divorced spouse was not entitled to innocent spouse relief with respect to joint returns because she was aware of her ex-spouse's Form 1099 income. On the 2013 return, the husband failed to report cancellation of debt income of $19,741 and $20,502 in retirement plan withdrawals. [*Lessard*, TC Summary Opinion 2017-95]

The IRS was able to obtain a judgment against a taxpayer for tax years before her divorce. The taxpayer was not relieved of the liability even though her former husband had made payments to the IRS with the proceeds from the sale of joint property for his separate tax debt. As directed by his attorney, the husband applied the payments only against his liabilities. (*U.S. v. Komlo*, DC PA 121 AFTR 2d 2018-1067)

CAUTION: A taxpayer cannot be forced to sign a married filing joint return. However, there is a doctrine called the "Tacit Consent" doctrine. If it was the "intent" of the spouses to file a joint return, it does not matter that only one of the spouses signed the return [*Hennen v. Comm.,* 35 T.C. 747, 748 (1961)]. If "Tacit Consent" applies, the fact that only one of the spouses signed the return does not change the legal status of that return.

COURT CASE: Pro se taxpayer wasn't entitled to married filing joint status for year for which his wife, who had long history of filing jointly with taxpayer in prior years, filed separate return claiming large but unfounded theft loss: notwithstanding incorrectness of most of information on wife's return, plus facts that she had previously been hospitalized for mental illness and that taxpayer obtained conservatorship order after subject year's return filing. He wasn't entitled to file on her behalf for year at issue absent proof that she wasn't able to file on her own and that he was duly authorized agent for her. (*Peter W. Moss v. Comm.*, TC Memo 2017-30)

There are numerous implications to filing separate returns. Some of these include (not an exhaustive list):

1. If one spouse itemizes, the other must also itemize deductions, even if total deductions are less than the standard deduction.

2. The taxpayer can deduct only expenses paid by the taxpayer. Community property states have differing rules with the allocation of income and expenses.

3. The credits for childcare, adoption, education, and earned income generally are not available.

4. If the taxpayer lived with the spouse during any part of the year, the taxable threshold for social security is reduced to zero. If the spouses lived apart for the entire year, the threshold increases to $25,000.

5. The exclusion of gain on the sale of a principal residence is limited to $250,000 versus $500,000 for a joint return; however, in situations where both spouses meet the requirements of IRC Sec. 121 this should not be an issue.

6. The benefit of the $25,000 passive loss exception for actively managed rental real estate may be totally or partially lost. [IRC Sec. 469(i)(5)]. If the spouses lived together at any time during the year the $25,000 is reduced to zero. If the spouses lived apart for the entire year, the amount is set to $12,500.

7. The ability to offset one spouse's passive income against another spouse's passive losses is lost.

8. The ability to use the other spouse's time for meeting the material participation test for real property is also lost when determining real estate professional status.

9. The phase-out of IRA deductions (or eligibility for a Roth IRA) starts at zero and ends when AGI reaches $10,000.

10. Contributions to an IRA allowed because of a spouse's compensation are not available to separate filers.

11. Spouses residing in a community property state, must generally report half of the total community income and deductions, regardless of who earned or paid such amounts. Income and deductions attributable to separate property are reported by the spouse who owns the property.

12. The limit on the capital loss deduction on a separate return is $1,500.

13. No exclusion is allowed for interest income from Series EE and I bonds used for higher education expenses [IRC Sec. 135(d)(3)].

14. The deduction for interest on qualified education loans is not available.

15. The SALT limit is $5,000 for MFS returns.

16. Taxpayers filing separate federal returns typically must also file separate returns for state income tax purposes.

CHANGING FILING STATUS AFTER ORIGINAL RETURN

If separate returns are originally filed, the spouses can elect to file an amended joint return (Form 1040X) within three years of the original due date (excluding extensions) of the separate returns [Reg. §1.6013-2(b)].

A change from joint to separate returns is more restrictive. If a joint return is originally filed, separate returns replacing it must generally be filed by their due date [Reg. §1.6013-1(a)(1), CCA 2014110].

COURT CASE: A widow filed a refund complaint seeking to have her belated married-filing-separate returns accepted, and thereby recover a portion of taxes paid for the years in which her since-deceased husband filed joint returns without her knowledge. The court denied her request on summary judgment, stating that she couldn't use her separate returns to undo earlier joint returns when—even though her husband had forged her signature—it was clear that she intended to file jointly, (See "Tacit Consent" rules discussed earlier). Notably, she left all tax matters to her husband, understood that he prepared and filed joint returns on her behalf, and never filed separate returns until years later. Moreover, even though her husband misrepresented to her that she didn't need to sign their joint returns, and even though such circumstance might provide grounds for an innocent spouse claim, it didn't change the above facts or provide grounds for a refund. (*Coggin v. U.S.*, 122 AFTR 2d 2018-5171)

QUALIFYING WIDOW

A taxpayer is eligible to file as a qualifying widow(er) with dependent child if all the following tests are met:

1. The surviving spouse was *eligible* to file a joint return with the decedent spouse for the year of death, regardless of whether they *filed* a joint return.

2. The decedent spouse died within two years and the surviving spouse did not remarry before the end of the year.

3. The surviving spouse has a child or stepchild who can be claimed as an exemption. (This does not include a foster child.)

4. This child lived in the surviving spouse's home all year, except for temporary absences.

5. The surviving spouse paid more than half the cost of keeping up a home for the year.

This filing status entitles the surviving spouse to use joint return tax rates and the highest standard deduction amount; it *does not* entitle the taxpayer to file a joint return. The tax rates are more favorable than the HOH rates.

HEAD OF HOUSEHOLD PREPARER DUE DILIGENCE REQUIREMENTS

The TCJA expanded the preparer due diligence penalty to determining the eligibility to file as head of household. [IRC Sec. 6695(g)]. This change is effective for tax years beginning after December 31, 2017. For failure to be diligent relating to a return or claim for refund filed in 2022 the penalty is $545 [Rev. Proc 2020-45]. For returns filed in 2021, the penalty has been adjusted for inflation to $540. [Rev. Proc. 2019-44]. (See Chapter 13 for additional due diligence information.)

The penalty applies to three of the refundable credits: the Child Tax Credit, American Opportunity Tax Credit, and the Earned Income Tax Credit, plus head of household filing status.

The penalty is imposed on each failure to comply with the due diligence requirement. Accordingly, total penalties of $2,180 on a single return may be assessed.

NOTE: The IRS has modified Form 8867 (Paid Preparer's Due Diligence Checklist).

Under IRC Sec. 6695(g) the tax return preparer must not have known, or have reason to have known, that any information used in determining the taxpayer's eligibility to file as head of household or any three refundable credits claimed on the return or claim for refund is incorrect.

1. Preparers cannot ignore information that is furnished or is known to the preparer.

2. The preparer is held to a reasonable and well-informed tax return preparer standard that requires contemporaneously documenting inquiries.

3. The return preparer must question information that appears to be incorrect, inconsistent, or incomplete and document the responses to those inquiries.

4. A practitioner cannot rely on the oral statements of the taxpayer, they must obtain and maintain in the file documents (e.g., children's medical or school record) that support the head of household determination. (See Chapter 13 for expanded discussion).

NOTE: The IRS published rules adding to the list of issues on which tax preparers must exercise due diligence or face penalties. The final rules were published on November 7, 2018, in the Federal Register and are available by visiting **www.federalregister.gov** and searching "tax return preparer due diligence penalty under Section 6695g."

Qualifying for Head of Household Status

To qualify for *head of household* (HOH) status, the taxpayer must be either unmarried or considered unmarried on the last day of the year. Further, the taxpayer must not be a surviving spouse or a nonresident alien at any time during the tax year [IRC Sec. 2(b)(3)(A)]. To meet the requirements, the taxpayer either—

1. Maintains a household (i.e., provides over half of the costs), which is principal place of abode for more than half of the tax year of—

   a. a *qualifying child* as defined in IRC Sec. 152(c), but not if the child is married and files a joint return, or

   b. a *dependent relative* for which an exemption can be claimed, or

2. Maintains a household which constitutes the principal home of the taxpayer's mother or father if the taxpayer can claim an exemption for such parent. This can be separate from the taxpayer's home.

If the qualifying individual *is not* a qualifying child, the dependent must be a *relative* as defined in IRC Sec(s). 152(d)(2)(A) through (G) [IRC Sec. 2(b)(3)(B)(i); CCA 200812024]. *Relatives* include a—

1. Child or a descendant of a child.
2. Brother, sister, stepbrother, or stepsister.
3. Father or mother, or an ancestor of either.
4. Stepfather or stepmother.
5. Son or daughter of a brother or sister of the taxpayer.
6. Brother or sister of the father or mother of the taxpayer.
7. Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

NOTE: Unrelated individuals who meet the qualifying relative test do not qualify a taxpayer for HOH status. Dependents who meet the qualifying relative test because of a multiple support agreement in which the taxpayer does not provide more than 50% of the support also do not qualify a taxpayer for HOH status. Relatives with incomes over the dependency amount do not qualify the taxpayer for HOH status even if the taxpayer provides more than half the cost of maintaining the home. The income limitation is $4,300 for tax years 2021 and 2020, respectively.

CHILD TAX CREDIT: The TCJA suspended personal exemption deductions for years 2018–2025. However, the TCJA increased the base child tax credit to $2,000, provided for a $500 nonrefundable nonchild credit, and increased the credit phase-outs. ARPA 2021 further increased the credit for 2021, to $3,600/$3,000 depending on the child's age and the taxpayer's MAGI (see Chapter 13 for more information). If the custodial parent releases the dependency exemption deduction (suspended in 2018), the custodial parent loses any allowable child tax credit. However, the custodial parent is still entitled to the childcare credit, earned income tax credit, exclusion for dependent care assistance benefits, and potential HOH status. (See Chapter11 for the requirements involved with the noncustodial parent claiming a child.)

PLANNING TIP: The ability to claim HOH status relies on the dependency tests that often center on the time spent with the parent. Thus, maintaining records of the amount of time, counting the nights, a child spends in each household is critical in joint custody situations.

CAUTION: If the qualifying person is a parent, the taxpayer must be able to claim their exemption. The taxpayer must pay more than half the cost of keeping up a home that was the main home for the entire year for the parent. A taxpayer is considered to be keeping up a main home for a parent if the taxpayer pays more than half the cost of keeping the parent in an adult care facility or home for the elderly (or paying more than half the cost for the parent's private residence).

More Than Half the Cost of Keeping Up a Home for the Tax Year

For this purpose, the cost of keeping up a home may include property taxes, mortgage interest, rent, utilities, property insurance, food consumed on the premises, and certain other household costs.

1. A taxpayer cannot include the rental value of a home they own, or the value the taxpayer's (or other household member's) services provided.

2. For this purpose, the taxpayer does not include the costs of clothing, education, medical care, vacations, transportation, and the like.

3. A qualifying person lives with the taxpayer in the home for more than half the tax year (excluding temporary absences, such as college). However, if the qualifying person is a dependent parent, the taxpayer may be able to claim head of household filing status even if the parent does not reside with the taxpayer.

ABANDONED SPOUSE RULE

A taxpayer is considered unmarried on the last day of the tax year and entitled to HOH status if all the following tests are met [IRC Sec. 2(b)(1)]:

1. The taxpayer files a separate return.

2. The taxpayer paid more than half the cost of keeping up a home for the tax year.

3. The taxpayer's spouse did not live in the home during the last six months of the tax year.

4. The taxpayer's home was the main home of his child, stepchild, or foster child for more than half the year.

5. The taxpayer must be able to claim an exemption for the child. A custodial parent releasing the exemption to the noncustodial parent meets this requirement.

COURT CASE: Many separated couples have run afoul of the rule that the spouse must not be a member of the household for at least the last six months of the year. In one case, even though her spouse had no clothes at her house or a key to the house, a taxpayer lost the right to file as HOH because she stated that, "I had a husband that I couldn't get rid of living in my house," and had instead moved herself out in August. (*Hopkins v. Comm.*, T.C. Memo 1992-326.)

PLANNING TIP: MFS is generally considered the least desirable filing status and the contrast with HOH status is striking. Among the potential benefits for someone who qualifies to file as HOH, (1) the credits for child care, earned income, education, and adoption; (2) the exclusion of Series EE bond interest income (used for higher education); deducting the interest on a qualified educational loan, converting a traditional IRA to Roth IRA; and (3) the freedom to use the standard deduction even if the taxpayer's spouse itemizes deductions on his return.

Taxpayers may qualify for HOH status without claiming the dependent (deduction is suspended for tax years 2018–2025).

EXAMPLE: HOH Status without Claiming the Dependent

Rita is divorced and has a child, Sam (age 15), who qualifies as a dependent. Her ex-spouse Eric claims Sam in 2021, and while there is no dependency exemption, Eric receives the child tax credit. Rita paid more than half the cost of keeping up a home for the year, and Sam lived with her in the home for seven months. Rita can file as HOH.

Variation: Assuming the same facts but Rita remarries and files a joint return. Even if she has released Sam's dependency exemption to Eric, Sam is still a qualifying child of Rita. Eric's home *was not* Sam's *principal residence* for more than half of the year.

Temporary absences do not necessarily disqualify the taxpayer from being able to file as HOH. If the absence is due to special circumstances such as illness, education, business, vacation, military service, or custody agreements, the absence will not affect residence requirements for HOH status as long as there is the reasonable assumption [Reg. §1.2-2(c)(1)] that—

1. The taxpayer or qualifying person will return to the household, and
2. The taxpayer continues to maintain the household in anticipation of return.

EXAMPLE: HOH Status with Temporary Absence of Dependent

Billy is divorced and has custody of his 21-year-old son Jack. Jack was living away from home for nine months (February–May and September–December) while attending school full time. Billy is concerned that he will not be able to claim HOH status because his son was absent for nine months of the year. However, he will still meet the residency requirement for HOH status because Jack intends to continue living with Billy when he returns from school and Billy is still paying all of the costs of maintaining the home.

Variation: Jack had the opportunity to spend the summer months as an exchange student in Mexico and did not return home for the entire year. As long as the expectation is that he will return home, he will still meet the residency requirements for Billy to file as HOH.

Unmarried parents and so-called "nontraditional" households make for challenging HOH calculations.

EXAMPLE: HOH Status for Nontraditional Households

Linda's unmarried son Corey lived with Linda all year and was 18 years old at the end of the year. Corey did not provide more than half of his own support and does not meet the tests to be a qualifying child of anyone else. As a result, he is Linda's qualifying child and because he is single, he *is* a *qualifying person* for Linda's claiming HOH filing status.

Variation 1: Same facts, except that Corey was 25 years-old at the end of the year and his gross income was $5,000. Because he does not meet the age test, he is not a qualifying child. Because his income exceeds the gross income test ($4,300 for 2021), he also is not a qualifying relative. As a result, he *is not* a *qualifying person* for HOH purposes.

Variation 2: Corey's girlfriend lived with him all year. Even though she may be a qualifying relative for dependency purposes if the gross income and support tests are met, she *is not* a *qualifying person* because of the lack of family relationship for HOH purposes.

Variation 3: Same facts as Variation 2, but the girlfriend's 10-year-old daughter Sara also lived with the taxpayer. Sara is not the taxpayer's qualifying child and because she is the girlfriend's qualifying child, she also is not Linda's qualifying relative. As a result, she is not Linda's qualifying person for HOH purposes. However, as the girlfriend's qualifying child, the daughter might allow the girlfriend to claim HOH status if she paid more than half the cost of maintaining the household for her and Sara and meets the other HOH requirements.

CAUTION: Given the due diligence penalties under Code Sec. 6695, taking aggressive positions regarding HOH filing status could end up costing a practitioner more than the tax return fee if the due diligence penalty is assessed.

SUSPENSION OF PERSONAL EXEMPTION DEDUCTIONS

The TCJA suspended the personal exemptions deduction for tax years beginning after December 31, 2017, and before January 1, 2026 (2018–2025). Accordingly, the Section 151 exemption amount is zero for those affected tax years.

While normally associated only with the personal exemption deductions on Form 1040, there are several tax benefits that require qualification of dependency:

- Child Tax Credit. A parent who releases the personal exemption to the non-custodial parent will not be eligible for the CTC
- American Opportunity Tax Credit. See issues with the CTC
- Form W-4 (Withholding Exemption Allowance Certificate). Exemptions are not specifically used on Form W-4 however the associated credits can be used to modify withholding
- Wage Levy Exemption. The amount exempt from the levy is the sum of $4,300 (2021) times the number of taxpayer dependents plus the standard deduction divided by the number of pay periods in the year

DEPENDENCY EXEMPTION SPECIAL RULES AND TERMS

There are special rules that apply throughout the provisions for what constitutes a dependent (i.e., these rules apply to both a qualifying child and/or a qualifying relative):

1. A dependent of another person cannot claim an exemption on their own return (pre-2018, post-2025) [IRC Sec. 152(b)(1)],
2. Generally, an individual who files a joint return with a spouse in a tax year cannot be a dependent of another taxpayer in that same year [IRC Sec. 152(b)(2)],
3. A dependent must be a U.S. citizen or national, or a part-year resident of the United States, Canada, or Mexico [Reg. §1.152-2(a)(1)]. However, this nationality test will not exclude a legally

adopted child who is not a U.S. citizen or resident if the taxpayer is a U.S. citizen or national and the taxpayer's home is the child's principal place of abode [IRC Sec. 152(b)(3)(B)].

ITIN REQUIREMENT: The PATH Act of 2015 modified certain rules related to ITIN application procedures and added rules regarding the term of existing and new ITINs [IRC Sec. 6109(i)]. All ITINs not used on a federal tax return at least once in 2017, 2018, or 2019 will expire on December 31, 2020.

For more information on ITINs, visit **www.irs.gov/individuals/international-taxpayers/itin-updated-procedures-frequently-asked-questions**.

DEPENDENCY EXEMPTIONS: QUALIFYING CHILD AND RELATIVE

The Working Family Tax Relief Act of 2004 (WFTRA) classifies dependents in two different categories under IRC Sec. 152:

- Qualifying children and
- Qualifying relatives.

WFTRA also adopted uniform language defining a qualifying child for purposes of the dependency exemption, child tax credit, earned income credit, dependent care credit, and head of household filing status.

QUALIFYING CHILD TESTS

A qualifying child must meet several tests:

Relationship

Must be the child, adopted child, eligible foster child (placed by an authorized placement agency or by judgment, decree, or other court order), grandchild, brother, sister, stepbrother, stepsister, or descendant of any of them.

Residency

The child must live in the same principal place of abode as the taxpayer for more than half of the tax year. It is intended that an individual will not fail this test because of temporary absences due to illness, education, business, vacation, military service, and other special circumstances.

Support

The child cannot have provided more than half of his own support.

NOTE: The taxpayer is not required to pay more than half the cost of maintaining the home to claim a child as a dependent. The only support rule that applies for a qualifying child is *the child does not provide more than half of his own support.*

Age Requirements

Generally, the child must be under age 19 as of the close of the tax year (under age 24 in the case of a fulltime student) or is permanently and totally disabled. Also, the qualifying child must be younger than the taxpayer (or spouse if filing jointly) claiming him or her as a dependent.

> **NOTE:** The IRS finalized Regulations on October 13, 2020 to clarify that the income limit still applies regarding qualifying relative status, even though personal exemptions were suspended by the TCJA. These rules will apply to taxable years 2019–2025. Taxpayers with qualifying relatives still can potentially receive the $500 non-refundable credit. These rules can be found in Reg. §1.152-2.

Qualifying Child Special Rules

There is a special rule allowing a custodial parent to release the exemption to the noncustodial parent for children of divorced or separated parents.

> **PLANNING TIP:** If the parents of a full-time student are eligible to claim the dependency exemption for the child but forego doing so, the child may be eligible to claim certain education credits on his own return. (Chapter 9 has more information.)

Two or More Taxpayers Claim a Qualifying Child

There are special tiebreaker rules when two or more taxpayers claim a qualifying child.

1. Parent wins over others. If a child would be a qualifying child with respect to more than one individual and those individuals do not otherwise agree on who will claim the dependency exemption for the child, the child is treated as the qualifying child of the parent(s).

2. Parent with the longer custody then higher AGI wins. If both parents claim the child as a qualifying child and the parents do not file jointly, the child is treated as the qualifying child of the parent with whom the child resided for the longest time during the year, or if the time was equal, then the parent with the higher AGI.

3. No parent: The person with the highest AGI wins. If no taxpayer is the child's parent, the child is treated as the qualifying child of the taxpayer with the highest AGI for the year. However, if an individual's parents may claim the individual as a qualifying child and neither parent chooses to do so, no other taxpayer may claim the individual as a qualifying child unless that taxpayer's AGI is higher than the highest AGI of any parent of the individual [IRC Sec. 152(c)(4)].

These rules do not apply if an otherwise qualifying taxpayer does not actually claim the child.

> **PLANNING TIP:** There are other provisions that use this so-called "uniform definition of a qualifying child" [i.e., head of household filing status under IRC Sec. 2(b); the child and dependent care credit under IRC Sec. 21, the child tax credit under IRC Sec. 24, and the earned income credit under IRC Sec. 32]. When this tie-breaker rule comes into play (i.e., more than one taxpayer claims a child as a qualifying child), the child is treated as the qualifying child of only one taxpayer for all these provisions. The rule is applied to these provisions as a group, not on a section-by-section basis (Notice 2006-86).

EXAMPLE: Qualified Child Status Tiebreaker

Charlotte is 13, does not provide any of her own support, and lives with her mother Chelsea and her grandmother Hillary in the same house for the entire year. Charlotte can be claimed as a qualifying child by both Chelsea and Hillary. She meets the relationship test for Chelsea because she is her daughter. She meets the relationship test for Hillary because she is Hillary's granddaughter (i.e., she is a descendant of Hillary's daughter). She meets the age, residency, and support tests for both Chelsea and Hillary. However, for purposes of the dependency rules, Charlotte would be treated as the qualifying child of Chelsea should both Chelsea and Hillary attempt to claim her. If this occurs, Charlotte cannot be treated as the qualifying child of Hillary for any purpose according to the principles of Notice 2006-86. There is no problem, however, if both Chelsea and Hillary agree on who claims Charlotte as a dependent.

CLAIMING A QUALIFYING RELATIVE AS A DEPENDENT

The qualifying relative must not be a qualifying child (of any taxpayer) and must satisfy certain tests [IRC Sec. 152(d)].

Relationship Test

In addition to the relatives listed earlier, *qualifying relationships* include: parents, grandparents, stepparents, brothers and sisters of parents, father-, mother-, sister-, brother-, son-, or daughter-in-law, or anyone who is a member of the taxpayer's household for the entire year.

Support Test

Taxpayer provided more than half of the relative's support for the year.

Income Test

Gross income is less than the personal exemption amount ($4,300 in 2020). This test disregards tax-exempt income (e.g., certain scholarships and the nontaxable portion of Social Security payments) and certain income earned by handicapped dependents for services performed at sheltered workshops [IRC Sec. 152(d)(4)].

EXAMPLE: Qualifying Relative Income Test

Thumper has a sister Bambi who lives with her. Thumper pays for all of Bambi's support. Bambi's only income is Social Security of $10,000, which she deposits in a savings account. Thumper is entitled to take Bambi's dependency exemption under the qualifying relative rules.

It is important to note that even if a child does not satisfy the *qualifying child* rules, he or she still may satisfy the *qualifying relative* rules.

EXAMPLE: Child as Qualifying Relative

Nathan graduated from high school two years ago and is 20 years old. He isn't going to school or working. He makes more than $4,300 in wages and lives at home with his mother, Amber.

Because Nathan is not a fulltime student and is over 18 years old, he is not a qualifying child. However, he meets the rules for being a *qualifying relative*. Amber is allowed a dependency deduction for Nathan.

What Is Support?

Support includes food, shelter, clothing, medical care, and education. It also includes items such as a wedding for a child (Rev. Rul. 76-184) and the cost of education. Generally, the amount of support is the amount of expense incurred in furnishing the item of support. If the support is in the form of property or lodging, the amount is the fair market value thereof [Reg. §1.152-1(a)(2)(i)].

Student loan proceeds used to pay for education count as support from the child if the child is the obligor (McCauley, 56 TC 48). However, amounts received as a scholarship by a student are not considered in measuring support.

Distributions from 529 plans and education savings accounts (ESAs) may also impact the issue of support. However, the IRS has provided no guidance on this issue. A taxpayer might take the position that 529 plan distributions are provided ultimately by the account owner (which is normally the parent). However, since an ESA is technically a custodial account, the beneficiary (student) becomes the account owner at majority (age 18 or 21, depending on the state). Therefore, distributions from an ESA might be deemed as being provided by the student for his own support.

Capital items provided to a child may represent support. An auto purchased and titled in the name of the child is an item of support of that child in an amount equal to its cost, whether provided by the parent or by the child (Rev. Rul. 77-282). An automobile purchased and owned by the parent but used by the child is not an item of support, other than out-of-pocket costs associated with the auto provided by the parent.

Only amounts actually expended during the year are considered *support* (Rev. Rul. 58-404).

COURT CASE: Petitioner's daughter received funds from scholarships, student loans, and earnings, as well as contributions from petitioner ($600), which she used for her support during 1966. Held, the amounts received as student loans and earnings are not to be disregarded under IRC Sec. 152(d) (of 1954) in computing the amount of the daughter's total support. Consequently, petitioner failed to establish that he contributed over half of his daughter's support during 1966 and is not entitled to a dependency exemption deduction for her for that year under IRC Secs. 151, 152 (of 1954).(*Philip J. McCauley*, 56 TC 48, 04/12/1971)

EXAMPLE: Qualifying Relative

Frank and Rose Miller help support Rose's mother, Norma. Norma lives rent free in one side of a duplex the Millers own. The fair rental value of the dwelling (unfurnished) is $8,400 a year. Norma provides her own furniture, but the Millers pay the utilities, which were $1,200 in the current year. Norma's income consists of $8,000 of social security benefits and $300 of interest income, all of which she spends toward her own support. The annual fair rental value of Norma's household furnishings is $1,200.

The Millers provide more than half of Norma's support for the current year. Their support is $9,600 ($8,400 value of dwelling plus $1,200 utilities) while the support Norma provides for herself is $9,500 (income of $8,300 plus $1,200 value of furnishings). Norma also meets the other tests for dependency as a qualifying relative (i.e., relationship and gross income). Thus, the Millers can claim Norma as a dependent on their Form 1040 and claim any benefits [e.g., the credit for other dependents for her]

Multiple Support Agreements

Generally, a taxpayer can claim a dependency exemption for a qualifying relative only if he provides more than half of that individual's support for the year, assuming all the other tests for a qualifying relative are met. In some cases, several taxpayers jointly provide support for an individual (e.g., several children support an elderly parent). If no one taxpayer provides more than half the support, the support test under the qualifying relative rules will not be met by any of them.

An exception to the support rule exists for multiple support situations. Qualified taxpayers who each provide more than 10% of an individual's support (and more than 50% collectively) can decide among themselves who will claim the exemption.

The following requirements must be met before a multiple support dependency exemption can be claimed:

1. The supported person must meet all of the tests for a qualifying relative, except the more-than-50% support test.

2. The taxpayer claiming the exemption must obtain the consent of each of the other taxpayers who pay more than 10% of the support and could, except for the more-than-50% support test, otherwise claim the supported person as a dependent.

3. The taxpayer claiming the exemption must be able to claim the supported person as a dependent (i.e., a qualifying relative), except for the more-than-50% support test.

The exemption does not have to be allocated to the taxpayer providing the most support; however, the taxpayer claiming the exemption must provide more than 10% of the total support.

Only one taxpayer can claim the exemption each year. However, the exemption does not have to be claimed by the same taxpayer each year. Taxpayers eligible to claim the exemption must enter into a new agreement each year for one of them to claim the exemption.

PLANNING TIP: Tax savings are maximized when the exemption is claimed by the person who will derive the most benefit.

Form 2120, Multiple Support Declaration, is provided to allow an eligible taxpayer to claim the exemption in a multiple support situation, although its use is not mandatory. The person claiming the dependent should obtain a signed statement from each eligible person (i.e., person who, absent the support test, would have qualified for the dependency exemption) that contributed over 10% of the dependent person's support, waiving the eligible person's right to claim the supported person as a dependent.

The IRS has a worksheet that may be used for determining support available at **https://apps.irs.gov/app/vita/content/globalmedia/teacher/worksheet_for_determining_support_4012.pdf**.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 501, *Exemptions, Standard Deduction and Filing Information*
- IRS Pub. 555, *Community Property*
- IRS interactive tax assistant at **www.irs.gov/help/ita/what-is-my-filing-status**

CHAPTER 11: DIVORCE

Learning Objectives

Completion of this course will enable participants to—

- Identify the new alimony rules.

WHAT'S NEW

- TCJA eliminates the deduction for alimony for post-2018 divorce or separation agreements.

- New divorce planning checklist.

ALIMONY FOR DIVORCE AGREEMENTS EXECUTED AFTER 12/31/2018

The first question to ask a new client who is divorced is, "When did you get divorced?" We never needed that information before. However, beginning with divorce or separation agreements executed after December 31, 2018, alimony will no longer be deductible by the payor spouse nor included in the income of the recipient spouse (TCJA §11051).

Alimony is taxable to the receiving spouse if the agreement is executed before January 1, 2019, under former IRC Sec. 71 before repeal by the TCJA.

Modification of Prior Agreements

Taxpayers who divorced prior to January 1, 2019, and who wish to have the new law applied, may modify the divorce decree after December 31, 2018, and the modification expressly provides that amendments made by the TCJA apply to the modification [Sec. 11051(c)(2) of the TCJA].

> **CAUTION:** An August 7, 2019, TIGTA report indicated the discrepancy between the alimony deduction tax and related income reported increased by 38% over a five-year period to $3.2 billion in 2016. (Visit **www.treasury.gov/tigta/auditreports/2019reports/201940048fr.pdf** for more information).

ALIMONY FOR DIVORCE AGREEMENTS EXECUTED BEFORE 1/1/2019

Alimony paid as a result of a pre-2019 agreement that has not been modified pursuant to the provisions of TCJA can be claimed as a deduction in arriving at AGI [IRC Sec. 62(a)(10); Reg. §1.62-1T(c)(11)]. Gross income includes amounts received as alimony for pre-2019 agreements that have not been modified to apply the TCJA provisions. [IRC Sec. 71(a)].

Under Reg. §1.71-1T, alimony (or separate maintenance payments) is any payment received by, or on behalf of, a spouse (which for this purpose includes a former spouse) of the payer under a divorce or separation instrument, that meets the following requirements:

1. The payment is in cash. Only cash payments (including checks and money orders payable on demand) qualify as *alimony* or *separate maintenance payments*. Transfers of services or property (including a debt instrument of a third party or an annuity contract), execution of a debt instrument by the payer, or the use of property of the payer do not qualify as alimony or separate maintenance payments (IRS Reg. §1.71-1T (Q/A 5).

COURT CASE: A taxpayer transferred real estate to her former spouse in satisfaction of an alimony requirement but was denied a deduction, as it was not paid in cash. (*Mehriar v. Comm.*, TC Memo 2015-126). The rule on this is quite clear.

2. The payment is not designated as a payment that is excludible from the gross income of the payee and nondeductible by the payer.

3. In the case of spouses legally separated under a decree of divorce or separate maintenance, the spouses are not members of the same household at the time the payment is made.

4. The payer has no liability to continue to make any payment after the death of the payee (or to make payment as a substitute for such payment) and the divorce or separation instrument states that there is no such liability.

5. The payment is not treated as child support.

COURT CASE: An attorney who earned a pre-divorce year bonus received in a divorce year was unable to deduct the half amount paid to the ex-spouse pursuant to their self-styled bonus alimony agreement. Notably, there was no evidence the bonus agreement ever became part of divorce/support order; and it didn't otherwise qualify as separation instrument since it provided for division of community property, not support. Taxpayer's claim that payment was in fact directed by support order was belied by above and facts that payment predated and was inconsistent with formula set out in support order. Also, there was no evidence that taxpayer and ex-wife were legally separated or living apart at time of payment. (*Paul S. Mudrich v. Commissioner*, (2017) TC Memo 2017-101).

Assuming all other requirements relating to the qualification of certain payments as alimony or separate maintenance payments are met, and the payer spouse is required to continue to make the payments after the death of the payee spouse, none of the payments before (or after) the death of the payee spouse qualify as alimony or separate maintenance payments (Reg. §1.71-1T, Q/A 10).

COURT CASE: In *Leslie v. Comm.* [121 AFTR 2d 2018-1991 (CA9)], a defective agreement that failed to provide that payments would terminate at the death of parties was held to be alimony. State law would have ended the payments in the event of death.

Not all payments under a divorce or separation instrument are alimony. Alimony does not include—

1. Child support,

2. Noncash property settlements,

3. Payments that are the spouse's part of community income,

4. Payments to keep up the payer's property, or

5. Use of the payer's property.

COURT CASE: The Tax Court held that $20,000 in temporary support payments made by an individual to his spouse did not qualify as alimony. The spouses were divorcing, and the payments were made under a temporary support agreement that was being negotiated by their attorneys, but never finalized. The Tax Court concluded that the payments did not qualify as alimony because they were not made under a divorce or separation instrument. (*James J. Faylor v. Comm.,* TC Memo 2013-143)

Payments must be in cash but are not required to be made directly to the ex-spouse. Cash payments to a third party under the terms of divorce, separation instrument or paid at the written request of the spouse (or ex-spouse) may qualify as alimony if all the following requirements are met:

1. The payments are in lieu of payments of alimony made directly to the spouse.
2. The written request states that both spouses intend the payments to be treated as alimony.
3. The taxpayer receives the written request from their spouse before he or she files a return for the year he or she made the payments.

Cash payments, checks, or money orders to a third party on behalf of a spouse treated as alimony, may include payments for a spouse's medical expenses, housing costs, taxes, tuition, premiums the taxpayer must pay for insurance on his life to the extent his spouse owns the policy, etc. The payments are treated as received by the spouse and then paid to the third party.

EXAMPLE: Payments Excluded from Alimony.

Under Irv's written separation agreement, his spouse lives rent-free in a home he owns, and Irv must pay the mortgage, real estate taxes, insurance, repairs, and utilities for the home. Because Irv owns the home and the debts are his, his payments for the mortgage, real estate taxes, insurance, and repairs are not alimony. Neither is the value of his spouse's use of the home.

If they otherwise qualify, Irv can deduct the payments for utilities as alimony. His spouse must report them as income. If Irv itemizes deductions, he can deduct the real estate taxes and, if the home is a qualified home, he can also include the interest on the mortgage in determining his deductible interest. It is important to note that this example, and the resulting treatment, is because Irv solely owns the home.

If the divorce or separation instrument states that the taxpayer must pay expenses for a home owned jointly with the spouse (or former spouse), some of the payments might be alimony. (See the following example from IRS Pub. 504, *Divorced or Separated Individuals*.)

EXAMPLE: Allocating Home Expenses between Alimony and Claimed Deductions

Table 4. **Expenses for a Jointly-Owned Home**

Use the table below to find how much of your payment is alimony and how much you can claim as an itemized deduction.

IF you must pay all of the ...	AND your home is ...	THEN you can deduct and your spouse (or former spouse) must include as alimony ...	AND you can claim as an itemized deduction ...
mortgage payments (principal and interest)	jointly owned	half of the total payments	half of the interest as interest expense (if the home is a qualified home).[1]
real estate taxes and home insurance	held as tenants in common	half of the total payments	half of the real estate taxes[2] and none of the home insurance.
	held as tenants by the entirety or in joint tenancy	none of the payments	all of the real estate taxes and none of the home insurance.

[1] Your spouse (or former spouse) can deduct the other half of the interest if the home is a qualified home.
[2] Your spouse (or former spouse) can deduct the other half of the real estate taxes.

ALIMONY RECAPTURE

Payments made in either of the first two years may be subject to re-computation that could reduce alimony amounts. (*Feldman v. Comm.*, TC Memo 1991-153)

The re-computation rule comes into play when alimony payments drop significantly from one year to another and applies only in the third year [IRC Sec. 71(f)]. The recapture amount is the sum of the following two calculations:

1. Excess second-year payments are calculated first. A second-year payment is considered excessive by the amount it exceeds the sum of the third-year payment plus $15,000.

2. Excess first-year payments are calculated next. A first-year payment is excessive if it exceeds the sum of $15,000 plus 50% of the un-recaptured second-year payment plus the third-year payment.

Certain payments can be exempted from recapture. These include [IRC Sec. 71(f)(5)]:

1. Payments made under a temporary support order (before the divorce or separation).

2. Payments that end within the three-year period because (a) either spouse dies, or (b) the payee spouse remarries.

3. Payments that vary but are fixed as a percentage or portion of income from a business, property, or employment (including self-employment) are not subject to recapture provided the agreement is effective for at least three years.

If alimony is recaptured, it is reporting in the following manner:

1. If the taxpayer deducted paid alimony, the recapture is reported as alimony received along with the former spouse's last name and social security number and crossing out "received" and entering "recapture."

2. If the taxpayer reported alimony received, the amount recaptured is reported on the alimony paid line along with the spouse's last name and social security number and crossing out "paid" and entering "recapture".

CHILDREN OF DIVORCED (OR SEPARATED) PARENTS

The default tax treatment is to treat a child of divorced or separated parents is the qualifying child of the custodial parent (Chapter 1 defines *qualifying child* in detail). However, the child will be treated as the qualifying child of the noncustodial parent if the special rule applies.

A child will be treated as the qualifying child of the noncustodial parent if all four of the following statements are true [IRC Sec. 152(e)]:

1. The parents:

    a. Are divorced or legally separated under a decree of divorce or separate maintenance,

    b. Are separated under a written separation agreement, or

    c. Lived apart at all times during the last six months of the year, regardless of whether they are or were married,

2. The child received over half of his or her support for the year from the parents,

3. One or both parents have custody of child for more than half of the year, and

4. The custodial parent signs a written declaration that he or she will not claim the child as a dependent for the year, and the noncustodial parent attaches the written declaration to his or her return.

The custodial parent must use either Form 8332 (Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent) or a similar statement (containing the same information required by the form) to make the written declaration to release the exemption to the noncustodial parent. The noncustodial parent must attach a copy of the form or statement to his tax return.

1. The "exemption" can be released for one year, for a number of specified years (for example, alternate years), or for a number of future years, as specified in the declaration, Form 8332 by the custodial parent.

2. The release must be non-conditional.

COURT CASE: In *Armstrong*, the custodial spouse's release of the dependency deduction, conditional on the husband remaining current on his child support obligation, was insufficient to shift the exemption, even though the husband was current. This decision was affirmed on appeal, with the court citing Pub. Law 98-369, which authorizes the IRS to implement Form 8332, written declaration and the signature requirements. (*Armstrong v. Comm.*, 113 AFTR 2nd 2014-1303)

NEW COURT CASE: A divorce decree was not enough when the wife as the custodial parent claimed the son and did not release the exemption as required by the divorce decree. (*Skitzki*, TC Memo 2019-106)

For pre-2009 agreements the release could be documented by attaching certain information to the noncustodial parent's tax return. See IRS instructions to Form 8332 for rules regarding pre-2009 agreements. Current regulations prohibit this for decrees and agreements effective after 2008.

For post 2008 decrees and agreements a noncustodial parent claiming an exemption must attach Form 8332. The custodial parent must sign either Form 8332 or a similar statement. The only purpose of this statement must be to release the custodial parent's claim to the child's exemption. The statement must be attached to the non-custodial parent's Form 1040 claiming the child.

The custodial parent can unilaterally revoke a release of claim to "exemption" that he or she previously released to the noncustodial parent on Form 8332 or a similar statement [Reg. §1.152-4(e)(3)]. The custodial parent can use Part III of Form 8332 for this purpose and must attach a copy of the revocation to his return for each tax year he claims the child as a dependent due to the revocation.

For the revocation to be effective, the custodial parent must have given (or made reasonable efforts to give) written notice of the revocation to the noncustodial parent in the prior year or earlier. The revocation must specify the year or years for which it is effective; if no specification is given, the notice is not effective.

COURT CASE: In *Engesser* (TC Summary Opinion 2018-29), the Tax Court chose a facts and circumstances test to determine where the daughter's primary residence was located. Mr. Engesser and Ms. Anthony had a child in 2006 and never married. In early 2014 (the year at issue), Ms. Anthony moved in with her mother (a few doors down the street). The court determined that it could not verify the primary residence of the child by the testimony of the parents, as both parties had claimed the child as a dependent without the issuance of Form 8332.

The court reviewed a letter from the child's medical practitioner that the child had an address of record maintained by Mr. Engesser. In another court proceeding to determine custody (for 2015 and 2016), the parties were granted joint custody, indicating the child primarily lived with Mr. Engesser. During the testimony of the parties, it was only indicated that the daughter lived "some days" with the mother (no log was provided to determine the number of days). The school records also indicated that the child lived with Mr. Engesser.

A majority of facts and circumstances indicated Mr. Engesser provided the primary residence of the child and was entitled to the exemption. He had not provided Form 8332 to Ms. Anthony, and there was no log indicating that Ms. Anthony had the child for a majority of the days, but there were indications from the school and medical provider that the child primarily lived with Mr. Engesser.

NOTE: In Rev. Proc. 2008-48, the IRS stated that it will treat a child as the dependent of both parents for employer-provided medical expense reimbursements, employer-provided health insurance coverage, excludible fringe benefits, deductible medical expenses, MSA accounts, and HSA accounts, regardless of whether the custodial parent releases the claim to the "exemption" under IRC Sec. 152(e)(2).

PROPERTY SETTLEMENTS

1041). This rule applies even if the transfer was in exchange for cash, the release of marital rights, the assumption of liabilities, or other consideration.

This rule does not apply in the following situations:

1. The spouse, or former spouse, is a nonresident alien.

2. Certain transfers in trust.

3. Certain stock redemptions under a divorce or separation instrument or a valid written agreement (Reg. §1.1041-2).

The term *property* includes all property whether real or personal, tangible, or intangible, or separate or community. It includes property acquired after the end of the marriage and transferred to the former spouse. It does not include services.

1. A property transfer is incident to divorce if the transfer occurs within one year after the date the marriage ends [IRC Sec. 1041(c)(1)] or is related to the ending of the marriage [IRC Sec. 1041(c)(2)].

2. A property transfer is related to the ending of the marriage if the transfer is made under the divorce or separation instrument or the transfer occurs within six years after the date the marriage ends [Reg. §1.1041-1T(b), Q&A 7].

Unless these conditions are met, the transfer is presumed not to be related to the ending of the marriage. However, this presumption will not apply if the taxpayer can show the transfer was made to carry out the division of property owned by spouses at the time the marriage ended.

Property received from a spouse (or former spouse if the transfer is incident to divorce) is treated as acquired by gift for income tax purposes. Its value is not taxable.

INCOME ALLOCATION

When a marriage terminates for tax purposes, a couple is no longer eligible to file a joint return. Thus, income for that year must be divided according to state provisions regarding community property or equitable distribution rules.

1. Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin, and Alaska is community property if a couple so designates.

2. All other states are equitable distribution states.

While rules between states differ, community property is generally all property acquired by either spouse during the marriage other than separate property. Property acquired during a marriage includes both parties' earned income, such as salaries, wages, and self-employment income, plus any income generated by community assets, such as rental income or portfolio income.

Generally, former spouses report their share of community income up to the time the divorce is final and report their separate income from the divorce finalization date through the last day of the tax year. Form 8958 will assist in determining the income of each former spouse.

EXAMPLE: Reporting Community Income for the Year of Divorce

Robert and Judy officially divorced on June 25, 20XX. On their tax returns, each will report their allocable share of community income from January 1, 20XX through June 25, 20XX. To that allocable income, they will add their individual earnings (and deductions) applicable to the period June 26, 20XX, through the end of the year [*Kathleen M. Williams*, TC Memo 1979-166]

To treat community property income as separate under IRC Sec. 66(a), all the following conditions must be met:

1. The legally married spouses live apart at all times during the tax year (temporary absences, including military service, are ignored),
2. The spouses do not file a joint return,
3. At least one spouse earned community income during the year, and
4. No portion of the community income is transferred between the spouses during the tax year.

When one spouse in a community property state inadvertently fails to include his or her share of community income on a tax return, the spouse can request relief from the community property income laws if all the following conditions established by IRC Sec. 66(c) are met:

1. A joint return is not filed.
2. The income not included is earned by the other spouse as an employee, a business owner, or a business partner.
3. The spouse can prove that he had no knowledge of the excluded community income. [Reg. §1.66-4(a)(2) lists the facts and circumstances.]
4. The spouse must show that, considering all the facts and circumstances, it would be inequitable to tax him on that item of community income. (Rev. Proc. 2013-34 provides further information on the factors the IRS uses to determine an inequity.)

RETIREMENT BENEFITS

A QDRO (Qualified Domestic Relations Order) is a judgment, decree, or court order (including an approved property settlement agreement) issued under a state's domestic relations law that:

1. Recognizes someone other than a participant as having a right to receive benefits from a qualified retirement plan (such as most pension and profit-sharing plans) or a tax-sheltered annuity.

2. A distribution or payment from a governmental, church or Section 457 plan is treated as made under a QDRO if it is made under a domestic relations order which meets IRC Sec. 414(p)(1)(A)(i) requirements. IRC Sec. 414(p)(11). Further, a Section 457 plan *will not* be treated as failing to meet its distribution requirements solely because of payments to an alternate payee under a QDRO. [IRC Sec. 414(p)(10)]

3. Relates to payment of child support, alimony, or marital property rights to a spouse, former spouse, child, or dependent of the participant, and

4. Specifies certain information, including the amount or part of the participant's benefits to be paid to the participant's spouse, former spouse, child, or other dependent.

NOTE: Benefits paid under a QDRO to the plan participant's child or other dependent are treated as paid to the participant. Benefits paid under a QDRO to the plan participant's spouse or former spouse generally must be included in the (former) spouse's income [IRC Sec. 402(e)(1)(A)]. If the participant contributed to the retirement plan, a prorated share of the participant's cost (investment in the contract) is used to figure the taxable amount.

PLANNING TIP: If a taxpayer receives an eligible rollover distribution under a QDRO as the plan participant's spouse or former spouse, he may be able to roll it over tax-free into a traditional individual retirement arrangement (IRA) or another qualified retirement plan [IRC Sec. 402(e)(1)(B); Reg. §1.402(c)-2, Q&A12(a)].

COURT CASE: The majority opinion of the Court of Appeals for the 2nd Circuit has held that two retroactive domestic relations orders (DROs), that were entered by a court on the day after the participant's death but made retroactively effective as of the earlier date of a settlement agreement, were valid qualified domestic relations orders (QDROs) that effectively assigned plan benefits to the participant's first wife. A vigorous dissent would have held that the plan benefits had vested in the participant's second wife on the date of the participant's death, and that the DROs were not QDROs. (*Yale-New Haven Hospital v. Claire M. Nicholls* (2015, CA2) 2015 WL 3498771)

EXAMPLE: Retirement Distributions

Sid has a vested balance in his employer's 401(k) plan of $300,000. Pursuant to a QDRO, the plan administrator makes an eligible rollover distribution of $120,000 ($150,000 gross distribution – $30,000 tax withholding) to Ann, Sid's former spouse and the alternate payee under the QDRO. Ann can roll the distribution over to an eligible retirement plan. To avoid current tax, she must roll over the entire $150,000 (even though she only received $120,000 net of the 20% withholding) within 60 days of receipt (or arrange for a direct trustee-to-trustee rollover of the funds to avoid the withholding).

Note that although current taxation is avoided by rolling over the distribution, any future distributions from Ann's account will be fully taxable, and will be subject to the 10% early distribution tax unless she is at least 59½ years-old or another exception applies.

If Ann chooses to keep all or part of the distribution (i.e., not roll it over), she is taxed on the amount she keeps but is not subject to the 10% early distribution tax (regardless of her or Sid's age) [IRC Sec. 72(t)(2)(C)]. Ann will receive a Form 1099-R for this distribution. Sid is not taxed on the distribution to Ann, nor does the QDRO distribution affect his eligibility for rollovers or favorable tax treatment of lump-sum distributions.

The transfer of all or part of a taxpayer's interest in a traditional IRA to spouse or former spouse, under a decree of divorce or separate maintenance or a written instrument incident to the decree, is not considered a taxable transfer. Starting from the date of the transfer, the traditional IRA interest transferred is treated as the (former) spouse's traditional IRA.

ESTIMATED TAX PAYMENTS

Divorcing (or divorced) taxpayers may allocate estimated tax payments in any manner agreeable to them.

1. Absent an agreement in an equitable distribution state, the estimated payments may be divided in proportion to each spouse's separate tax liability.

2. In a community property state, to the extent that the tax payments are made from community property, the amounts are divided equally between the parties.

Each spouse should attach a schedule to their separately filed returns detailing the total amount of tax estimates paid, the social security numbers of each spouse, and the amounts and explanations of the allocation method.

Agreeing to the allocation and filing accordingly, will avoid hours of clean up after the fact.

PLANNING TIP: If a taxpayer claims such allocated estimated tax payments on his tax return, the practitioner should enter the spouse's (or former spouse's) social security number in the space provided on the front of Form 1040.

ALLOCATING TAX CARRYFORWARDS IN DIVORCE

Capital loss carryforwards are allocated based upon each spouse's separate capital losses. Gains and losses on jointly owned or community property is generally divided equally between the spouses.

A joint charitable contribution carryforward is apportioned between the spouses in the ratio of what separate carryforwards would have been had the spouses filed separate returns for the year the carryforward arose.

A joint net operating loss (NOL) carryforward is apportioned between the spouses in the ratio of what separate NOL carryforwards would have been had each spouse separately computed income.

An alternative minimum tax (AMT) credit carryforward is allowed against regular tax for the portion of a prior year's AMT attributable to timing differences. There is no published authority on how to allocate AMT carryforward credits between divorcing spouses.

Suspended general business credit carryforwards should follow the property or business giving rise to the credit.

With regard to the investment interest expense carryforwards, there is no administrative or judicial authority for an allocation. Any reasonable method (e.g., tracing back to the source property) may work.

With regard to suspended passive activity losses, the IRS *MSSP Guide on Passive Activity Losses* states that the transfer of the underlying property between spouses is a gift consistent with IRC Sec. 1041(b)(1). According to IRC Sec. 469(j)(6), a passive activity disposed of by gift requires that suspended losses be added to the property's basis immediately prior to the instant of the gift.

In the year of the divorce (and dividing of the stock), each party reports his share of current-year S corporation activity. The transferor gets all the suspended losses (if sufficient basis exists in the year of transfer). In the year after the transfer, the suspended losses are split between the two spouses (or former spouses) by their respective ownership at the beginning of that tax year.

WHERE TO GO FOR MORE INFORMATION

The following publications can be found at **www.irs.gov**:

- IRS Pub. 504, *Divorced or Separated Individuals*
- IRS Pub. 555, *Community Property*

APPENDIX 11A: CLIENT DIVORCE CHECKLIST

Client: ______________________________

Case Caption: ______________________________

Prepared By: ____________________ Date: ____________________

	Yes	No	N/A
1. FILING STATUS			
a. Was the divorce finalized by year-end?	____	____	____
b. If not:			
(1) Does the abandoned spouse rule apply (IRC Sec. 7703)?	____	____	____
(2) Should the client agree to file a joint return with the spouse?	____	____	____
Practical Considerations: • Is the client comfortable being fully liable for any tax, interest, and penalties due? • Are there tax issues that can be avoided or reduced by a separate filing? • If a joint return is selected, will innocent spouse status protect the client? • If not, has the client been advised in writing of the risk of filing jointly? • Is there a tax cost to filing separately?			
c. Can a decree of separate maintenance (or the equivalent) be obtained to permit filing as a single individual or head of household?	____	____	____
2. PROPERTY SETTLEMENTS			
a. Has legal title to all assets and their classification as marital, community, or separate assets been determined? (Consider community property implications as appropriate.)	____	____	____
b. Has the tax basis of all appropriate assets been determined?	____	____	____
c. Regarding a sale of any assets expected to be disposed of shortly after the settlement, have the tax consequences been estimated and communicated to the client?	____	____	____
d. Have depreciation and other recaptures been considered on such sales?	____	____	____
e. In determining the proper settlement, have the after-tax values of the proposals been estimated?	____	____	____
f. Have any liabilities on the properties transferred between spouses been considered?	____	____	____
g. If a trust is being used, have its tax consequences been considered?	____	____	____

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	Yes	No	N/A
h. If the settlement involves a series of payments, should life or disability insurance on the payor be required? [See Temp. Reg. 1.71-1T(b), Q&A 6 and Rev. Rul. 70-218 for guidance on how to treat the premiums.]	____	____	____
i. Will any required transfers of property occur either during the marriage or be incidental to the divorce (to qualify for Section 1041 treatment)?	____	____	____
j. Are there any transfers of employer stock options or deferred compensation?	____	____	____
k. If so, has Rev. Rul. 2002-22 and its applicability been considered, as well as the employer's knowledge of same?	____	____	____
l. Are any property transfers scheduled to take place within one year of the date of divorce or separation?	____	____	____
m. Are any property transfers scheduled to take place within the second through sixth years after the date marriage ends pursuant to a divorce or separation instrument?	____	____	____
n. Are there any transfers of ownership interests in a closely held corporation or entity?	____	____	____
o. Are there any transfers of assets owned by a closely held corporation or entity?	____	____	____
p. Is there transfer of savings bonds?	____	____	____
q. Has the potential of using a property settlement to mimic deductible alimony been considered?	____	____	____
3. PRINCIPAL RESIDENCE			
a. If the marital residence is sold:			
(1) Will it qualify as the client's principal residence at the time of sale?	____	____	____
(2) Will any part of the gain be eligible for exclusion?	____	____	____
b. Has the client's tax cost of selling the residence been estimated?	____	____	____
c. Will the residence be transferred to the client as part of the settlement?	____	____	____
d. If yes, has the basis been reviewed to determine if it includes any improvements or other additions to cost (and any needed adjustment for prior deferred gain)?	____	____	____
4. ALIMONY AND CHILD SUPPORT			
a. Have the tax consequences of classifying support payments as alimony or child support been discussed with the client (including the consequences of such classification on the dependency exemption)?	____	____	____
b. For pre-TCJA divorces, if the proposed payment is to be alimony, are the following requirements met:			
(1) The payments are in cash or cash equivalents (including cash payments made to a third party on the payee's behalf)?	____	____	____
(2) The payments are made pursuant to a decree, court order, or written agreement?	____	____	____
(3) The payments are not designated in the divorce or separation instrument as nonalimony or child support?	____	____	____
(4) The parties will not file a joint return?	____	____	____

DIV-PA-11.6 (Continued)

	Yes	No	N/A
(5) The parties are not members of the same household at the time of the payments?	____	____	____
(6) The payments terminate on the death of the receiving spouse?	____	____	____
(7) The payments are made directly to or for the benefit of a spouse or former spouse?	____	____	____
(8) The payments do not reduce upon the attainment of a certain age or educational level by a minor child (i.e., are not deemed child support)?	____	____	____
(9) The payments do not trigger alimony recapture by decreasing more than $15,000 in either the second or third year?	____	____	____
(10) The payments are not contingent on any subsequent event?	____	____	____
c. If the payments are to be child support, are the following requirements met:			
(1) The amount is specifically stated in the agreement or decree as child support?	____	____	____
(2) The amount is reduced based on an event that is related to or associated with a child?	____	____	____
5. RETIREMENT PLANS			
a. Have the client's interests in retirement plans been reviewed (including interests in the spouse's plans)?	____	____	____
b. Should a pension valuation expert be retained for further analysis (for deferred benefit plans)?	____	____	____
c. Does the proposed settlement or decree provide for preparation of a Qualified Domestic Relations Order (QDRO) that conforms to the requirements of the plan sponsor?	____	____	____
d. Does the client need to change retirement plan beneficiary designations?	____	____	____
6. CHILD DEPENDENCY STATUS			
a. Have the parties addressed the issue of which spouse will claim the children as dependents?	____	____	____
b. Should the client waive their right to claim any children as dependents—			
(1) annually?	____	____	____
(2) permanently?	____	____	____
c. Is there a copy of the executed Form 8332 in the practitioner's file?	____	____	____
d. Does the client benefit from claiming the children as dependents?	____	____	____
e. If no, should some other arrangement be considered?	____	____	____
f. If the client is the noncustodial parent, have the rules for noncustodial parents been met if the dependency exemption is awarded to him or her?	____	____	____
7. OTHER ISSUES			
a. Do the client's will, trusts, or power of attorney documents need to be changed?	____	____	____
b. Do insurance policy beneficiaries need to be changed?	____	____	____
c. Should banks and other financial institutions be notified of the divorce and should signature authorities be changed?	____	____	____

PA-11.6 (Continued)

	Yes	No	N/A
d. Have the appropriate creditors been notified of the divorce?	____	____	____
e. Have all guarantees and endorsements been reviewed to determine whether the client has a contingent liability that needs to be addressed?	____	____	____
f. Have taxable income and deductions been properly allocated in the year of divorce?	____	____	____
g. Have prior-year tax returns been reviewed for the presence of any tax carryforward items and has provision been made for allocating the carryforwards?	____	____	____
h. Have any estimated tax payments been made for the year of termination of the marriage? If so, has an allocation been agreed upon?	____	____	____
i. If applicable, has the client's estimated tax safe harbor amount been recalculated for the change of filing status?	____	____	____
j. If applicable, has the client been provided with adequate security for a stream of future payments that are to be made by the ex-spouse?	____	____	____

DIV-PA-11.6 (Continued)

CHAPTER 12: KIDDIE TAX

Learning Objectives

Completion of this course will enable participants to—

- Determine whether a child is subject to the kiddie tax

FILING REQUIREMENTS FOR DEPENDENTS

For 2021, dependent single individuals who are under age 65 and not blind are required to file a return if—

1. Unearned income is over $1,100, or
2. Earned income is over $12,550, or
3. Gross income is more than the larger of—
    a. $1,100, or
    b. Earned income up to the standard deduction of $12,550.

For 2021, for dependent individuals 65 or older, or blind, and who are dependents, these thresholds are increased by the additional standard deduction amount of $1,700.

KIDDIE TAX REMODIFIED

The kiddie tax was designed to counteract family income shifting techniques by taxing the children's unearned income at higher tax rates.

A child is subject to the kiddie tax if [IRC Sec. 1(g)(2)]—

1. The child has not attained age 18 as of the close of the tax year; or has *earned income* that does not exceed half of his or her support and is either age 18 or a fulltime student age 19–23,
2. The child's investment income exceeded $2,200 for 2021,
3. Either parent of the child is alive at the end of the tax year, and
4. The child is required to file a tax return but does not file a joint return for the tax year.

For children over age 17, the kiddie tax applies only to children whose earned income doesn't exceed 50% of their support.

Unearned Income

IRC Sec. 1(g)(4)(A)(i) defines *unearned income* negatively as the, "portion of the adjusted gross income for the taxable year which is not attributable to earned income [as defined in IRC Sec. 911(d)(2)]." *Unearned income* includes all income except wages, salaries, and self-employed earnings.

The instructions to Form 1040 state:

> Unearned income includes taxable interest, ordinary dividends, capital gains (including capital gain distributions), rents, royalties, etc. It also includes taxable social security benefits, pension and annuity income, taxable scholarship and fellowship grants not reported on Form W-2, unemployment compensation, alimony, and income (other than earned income) received as the beneficiary of a trust.

The kiddie tax taxes the child's unearned income, in excess of the threshold, at the parents' tax rates.

OBSERVATION: When analyzing IRC Sec. 1(g)(2), note that a child under age 18 is subject to these rules regardless of the amount of their earned income. It is only after the child reaches age 18 that the question of whether the earned income exceeds half of his/her support becomes an issue. After age 18, these rules only apply to full-time college students whose earned income does not exceed half of his or her support.

Further, the kiddie tax rules are not impacted by the dependency rules. Potentially, a child filing a single return can be subject to the kiddie tax regardless of whether he is claimed as a dependent by his/her parents or not.

EXAMPLE: Aging out of the Kiddie Tax

Mike left home and school at the beginning of the year, severing all contact with his parents for the year. He is age 18 and supports himself by working part-time and liquidating securities that were gifted to him. If his unearned income exceeds the kiddie tax threshold and his earned income is not more than half of his support, he is subject to the kiddie tax. Starting at age 19, assuming Mike does not return to school he is no longer subject to the kiddie tax provision.

THE KIDDIE TAX CALCULATION

An Individual claimed as a dependent is allowed a limited standard deduction. For 202 the deduction is the greater of—

1. $1,100, or

2. The sum of $350 and earned income not to exceed the allowable standard deduction. The standard deduction for a single individual is $12,550 in 2021.

EXAMPLE: Kiddie Tax Calculation

Little Ricky age 17 earns $2,000 delivering newspapers. He also has $1,300 in interest income. His standard deduction is $2,350 ($2,000 earned income plus $350, limited to the standard deduction for the year). Therefore, none of Ricky's earned income will be subject to tax because of the increased standard deduction. Of the remaining $950 ($3,300 total income less $2,350 standard deduction) will be taxed at 10% rate.

> **NOTE:** Services performed by individuals under the age of 18 in the delivery or distribution of newspapers or shopping news are exempt from self-employment taxes [IRC 3121(b)(14)].

A *student* is defined in the same manner as the dependency rules. A *student* is an individual who is a fulltime student for five calendar months during the calendar year. [IRC Sec. 152(f)(2)].

> **NOTE:** Dependents between ages 19 and 23 are not subject to the kiddie tax if they fail to meet the definition of a *fulltime student*.

> **NOTE:** A child born on January 1, 2003, is considered to be age 19 at the end of 2021. A child born on January 1, 1997, is considered to be age 24 at the end of 2021.

Support is defined the same way as it is for purposes of the dependency rules [IRC Sec. 152(c)(1)(D)]. (See Chapter 1 for further information.)

REPORTING THE KIDDIE TAX

By default, the kiddie tax income is reported on "Form 8615 Tax for Certain Children Who Have Unearned Income" and is filed with the child's tax return. As with prior law the parents can elect to report the kiddie tax on the parents return provided the requirements for filing "Form 8814 – Parent's Election to Report Child's Interest and Dividends" are met.

The election is made by attaching Form 8814, Parent's Election to Report Child's Interest and Dividends, to the parents' return. This is available only if:

The child has not attained age 18 as of the close of the tax year; or whose earned income does not exceed half of his or her support and is either (a) age 18 or (b) a fulltime student age 19–23 at the end of the year and—

1. The child's income entirely comprises interest and dividends (including capital gain dividend distributions and Alaska Permanent Fund dividends),
2. The child's gross income is more than $1,100 for 2021 and less than $11,000 for 2021 (Rev. Proc. 2020-45),
3. The child is required to file a return but does not file a joint return for the year,
4. No estimated tax or backup withholding payments for the year have been made in the child's name and social security number,
5. No federal income tax was withheld from the child's income, and
6. The parents file a joint return or, if filing separate returns, the parent with the higher taxable income makes the election.

A separate Form 8814 must be filed for each child whose income the parents choose to report when—

1. The child's income, reduced by the $2,200 base amount, is reported on the "Other income" line of the parents' Form 1040, with the notation, "Form 8814;"

2. Any portion attributable to capital gain dividend distributions is reported on Schedule D; and

3. Any portion attributable to qualified dividends is reported on lines 3a and 3b of the parents' Form 1040.

Advantages of the Form 8814 reporting include—

1. Administrative convenience.

2. Savings in tax return preparation fees for the children.

3. Use of the child's interest and dividends to offset the parents' investment interest expense.

4. Use of the child's capital gain distributions to offset the parents' capital losses.

5. Increases AGI for computing charitable contribution limits.

6. Opportunity (depending on state law) to potentially avoid state taxation on the $1,100 that is automatically taxed at a 10% federal rate.

Disadvantages of the Form 8114 reporting include—

1. The additional income affects the parents' AGI-sensitive deductions such as the $25,000 rental real estate loss allowance, IRAs, medical expenses, casualty losses (if applicable), miscellaneous itemized deductions (suspended for tax years 2018-2025), and itemized deduction phase-out for high-income taxpayers (suspended for tax years 2018-2025).

2. Possible underpayment penalties (if the parents' estimated tax payments and/or withholding was not adjusted for the additional income).

3. Loss of certain deductions for the child (e.g., penalty on early withdrawal of savings, increased standard deduction if child is blind).

4. Potential adverse state tax consequences [many states do not restrict tax benefits (e.g., personal exemption, temporarily reduced to $0 for tax years 2018-2025 on the federal return but may be allowable on the state return) for minor taxpayers; thus, the child's income may be taxed at a higher state rate if included on the parents' return.]

5. Possible IRS Form 1099 matching notices.

6. Childcare, earned income, adoption, and education credits could be adversely affected.

7. Child's AMT preferences (e.g., tax-exempt interest from a private activity bond) are included in parents' return.

8. A slightly higher tax may result because a 10% rate is automatically applied to the child's first $1,100 of unearned income even though a 0% capital gain rate may otherwise apply.

9. Child's income is more likely to become subject to the 3.8% NIIT due to parent's higher AGI.

AVOIDING THE KIDDIE TAX

Avoiding the kiddie tax can result in significant tax savings. Often the child's income can be subject to little or no tax.

Taxpayers can keep annual investment income below the $2,200 limit by using the following methods

1. Contribute to Section 529 plans and Coverdale educational savings accounts. Parents and grandparents can avoid the kiddie tax issue and save for college at the same time. Consideration should be given to contributing the child's assets from UGMA and other currently taxable accounts.

> **NOTE:** Contributions to Section 529 plans must be made in cash. The liquidation of these investments already in the child's name can trigger the kiddie tax.

2. Purchase growth-oriented stocks and mutual funds that produce little or no current income.

3. Purchase tax-exempt securities.

4. Invest in U.S. Series EE bonds with maturities beyond the kiddie tax years and recognize the income at maturity. There is also an exclusion for Series EE bond interest used for certain educational purposes. (See Chapter 9, Education and ABLE Planning for more information).

5. Use annuity and cash value live insurance contracts that defer income beyond the kiddie tax years.

> **NOTE:** While annuity and cash value life insurance contracts can be great ways to defer or create tax-free income, they are normally not great vehicles for college education savings.

6. For children with compensation, contributions can be made to Roth IRA accounts.

Children 18 or older earning more than one-half their support are not subject to the kiddie tax. Accordingly, a child with a reasonably high-paying job, or earnings from the family business, can take advantage of his or her lower tax bracket.

> **CAUTION:** Proceed with caution when using income and asset-shifting strategies for children who are eligible for need-based financial aid.

The kiddie tax only applies to fulltime students; the tax does not apply to students ages 19–23 who are attending school on a part-time basis. Often, uncommitted students and their families are better off if the child delays college or attends school on a part-time basis.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 501, *Exemptions, Standard Deduction, and Filing Information*
- IRS Pub. 929, *Tax Rules for Children and Dependents*
- IRS Topic Number 553, Tax on a Child's Investment and Other Unearned Income (Kiddie Tax)
- *PPC's 1040 Deskbook*
- *PPC's Tax Planning for Higher Income Individuals*

CHAPTER 13: PERSONAL AND BUSINESS TAX CREDITS

Learning Objectives

Completion of this chapter will enable participants to—

- Identify personal and business tax credits for which clients may qualify.
- Determine whether tax credits are refundable and what forms to use for filing.

WHAT'S NEW

Personal Tax Credits

- Advance Child Tax Credit – For 2021 only
- Changes to EITC eligibility
- Child and Dependent Care Credit – Increased for 2021

SUMMARY OF PERSONAL TAX CREDITS

An awareness of the credits available to taxpayers can make practitioners heroes in their clients' eyes. Additional details provided by the IRS for the following credits can be found at **www.irs.gov/credits-deductions-for-individuals**. Most of these credits are discussed in greater detail later in this chapter or as noted in other chapters in the manual.

IRC Sec.	Credit Title	Form Number	IRS Pub.
Family and Dependent Credits			
7527A	Advance Child Tax Credit	NA	5538/5549/5534-E
24	Child Tax Credit and Credit for Other Dependents	8812	972
26/6428B	Recovery Rebate Credit (EIP)**	See Chapter 5	5486
32	Earned Income Credit	Schedule EIC and Form 8867	596/5334
129	Child and Dependent Care Credit and Exclusion	2441	17/503
137	Adoption Credit and Income Exclusion	8839	17/21/972
22	Credit for the Elderly and/or Permanently Disabled*	Schedule R	524/554

IRC Sec.	Credit Title	Form Number	IRS Pub.
Income and Savings Credits			
25B	Saver's Credit	8880	17, 590-A
901	Foreign Tax Credit**	See Chapter 43	514
Homeowner Credits			
25D	Residential Energy-Efficient Property Credit	5695	17/530
25	Mortgage Interest Credit*	8396	17/936
Health Care Credits			
36B	Premium Tax Credit	8962	974
35	Health Coverage Tax Credit	8885	974
Education Credits			
25A	American Opportunity Credit and Lifetime Learning Credit**	Chapter 6	970

Notes:

* Credit Not Discussed in this Manual—see Form Instructions

** Credit discussed elsewhere in this manual—see the Table of Contents

ADVANCE CHILD TAX CREDIT (IRC SEC. 7527A)

For 2021 only, the American Rescue Plan Act of 2021 (ARPA 2021) increased the refundable amounts of the Child Tax Credit (as this manual went to press, the Biden Administration has proposed an extension of this refundable credit). The refundable portion is—

- Children less than age 6: $3,600
- Children older than 5 but not yet 18: $3,000

As part of the increase of the refundable portion of the child tax credit, the IRS has been instructed to make advance payments of at least 50% of the refundable credit. Unless they opt out, starting in July 2021, taxpayers will receive payments from the Treasury in the amount of $300 or $250 per eligible child, per month. The payments will be made to approximately 39 million households representing 88% of all U.S. children. The payments will be based on the information contained in taxpayers' 2020 returns (if filed), or their 2019 tax returns.

The IRS has provided a tool on its website for most of the issues associated with management of the Advance Child Tax Credit Payments (**www.irs.gov/credits-deductions/advance-child-tax-credit-payments-in-2021**).

Manage Payments

The IRS has provided a manage payments tool to allow a taxpayer to:

- Determine if they are enrolled to receive payment, or
- Unenroll to stop getting advance payments, or
- Provide or update your bank account information for monthly payments.

Any of these steps can be taken at any time.

Other Program Assistors include:

- Non-filers can enter their information to initiate their monthly payments.
- Check Eligibility
- Additional Information of ACTC:
    - Publication 5538, *A Step-by-Step Guide to Using the Non-Filer Tool*
    - Publication 5549, *IRS User Guide: Advance Child Tax Credit Update Portal*
    - Publication 5534-E, *Advance Payments of the Child Tax Credit: Which Online Tool Should Be Used*
    - Questions and Answers About the Advance Child Tax Credit Payments
    - 2021 Child Tax Credit and Advance Child Tax Credit Payments: Resources and Guidance
    - Understanding Letter 6416 or Letter 6416-A. These letters were mailed out by IRS in June 2021and provide estimated Child Tax Credit (CTC) amounts for tax year 2021 and inform taxpayers they may be eligible to receive advance CTC payments.
    - Understanding Your Letter 6417

Upon filing the 2021 return, these payments will be reconciled, a process the IRS has labeled a “true up.” At that time, the total eligible credit will be determined, and the taxpayer will owe the Treasury additional funds or will be credited with a refundable credit if they qualify. The phaseouts will work in two steps.

Phaseout Number One

Thresholds:

- Single Filers: $75,000
- Head of Household: $112,500
- Married Filing a Joint Return: $150,000

Step One

The first phaseout can reduce the Child Tax Credit to $2,000 per child. This phaseout will be applied by a reduction of the credit by $50 for each $1,000 (or fraction thereof) that exceeds the first threshold, per child. So, the first phaseout step can reduce only the $1,600 increase for qualifying children ages 5 and under, and the $1,000 increase for qualifying children ages 6–17, at the end of 2021.

Phaseout Number Two

Thresholds

- Other than married filers: $200,000
- Married filing joint filers: $400,000

Step Two

The second phaseout reduces the Child Tax Credit by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds the income threshold described above that is applicable to the taxpayer.

If it is desired by the taxpayer to return a payment, the IRS has indicated that taxpayers who receive an advance child tax credit that they didn't qualify for or, for other reasons, wish to return the payment, should make those returns by using the same procedures which apply to returning Economic Impact Payments that were provided by the Coronavirus Aid, Relief, and Economic Security (CARES) Act (PL 116-136).

If the payment was by Paper Check:

1. Write "Void" in the endorsement section on the back of the check.
2. Mail the voided Treasury check immediately to the appropriate IRS location (this can be found on the Economic Impact Payment Information Center website at **www.irs.gov/newsroom/economic-impact-payment-information-center-topic-i-returning-the-economic-impact-payment**.)
3. Don't staple, bend, or paperclip the check.
4. Include a brief explanation stating the reason for returning the check.

For cashed payment checks or direct deposit payments:

1. Submit a personal check, money order, etc., immediately to the appropriate IRS location listed in the link above (Step 2)

2. Make the check/money order payable to "U.S. Treasury," write “2021CTC,” and the taxpayer identification number (Social Security number, or individual taxpayer identification number) of the recipient of the check.

3. Include a brief explanation of the reason for returning the Advance Child Tax Payment

Miscellaneous Advance Child Tax Credit Issues

1. Payments may not be offset against amounts the taxpayer or spouse owes in past-due child support.

2. Payments will not be reduced (that is, offset) for overdue taxes from previous years or other federal or state debts that the taxpayer owes.

3. If the taxpayer receives a refund when they file their 2021 tax return, any remaining Child Tax Credit amounts included in their refund may be subject to offset for tax debts or other federal or state debts they owe. If the taxpayer files a joint 2021 tax return and the couple receives a refund, any remaining Child Tax Credit amounts included in their refund may be subject to offset for tax debts or other federal or state debts the spouse owes. The taxpayer can file Form 8379 (Injured Spouse Allocation) with the 2021 tax return.

4. Advance Child Tax Credit payments are not exempt from garnishment by non-federal creditors under federal law. Therefore, to the extent permitted by the laws of the taxpayer’s state and local government, their advance Child Tax Credit payments may be subject to garnishment by their state, local government, and private creditors, including pursuant to a court order involving a non-federal party (which can include fines related to a crime, administrative court fees, restitution, and other court-ordered debts).

5. Advance Child Tax Credit payments cannot be counted as income when determining if the taxpayer or anyone else is eligible for benefits or assistance, or how much the taxpayer or anyone else can receive, under any federal program or under any state or local program financed in whole or in part with federal funds.

EXAMPLE: Effects of Advanced Child Tax Credit payments

Jon and Jacquie have two eligible children; one is age 2 and the other is age 6 (a child that Jacquie had with her first husband) who live with them. For 2020 they claimed both children. Their 2020 MAGI on their MFJ return was $145,000. As Jon and Jacquie were below the threshold of $150,000 on their 2020 return, they will receive monthly payments starting in July of $550 based on their 2020 return.

Scenario 1: Jon and Jacquie in 2021 started new jobs with a 50% pay raise. As a result of that raise Jon and Jacquie's MAGI for 2021 ended up being $200,000. Jon and Jacquie will not be eligible for the Advance Child Tax Credit (IRC Sec. 7527A); however, they will be eligible for the Child Tax Credit (IRC Sec. 24). As the six payments they received were considered advanced refunds they will need to "repay" the amount of ACTC = $3,300. They are however within the threshold of the CTC and will have their income tax amount reduced by 2 × $2,000 = $4,000 (the non-refundable portion).

Scenario 2: When Jon and Jacquie got their pay raises Jon contacted his Gear Up trained tax practitioner, who noted that Jon and Jacquie had not been participating in their 401(k) plan. Jon and Jacquie each made their maximum elective deferrals of $19,500 each for 2021 reducing their MAGI by $39,000, their MAGI will now be $161,000. Jon and Jacquie will be subject to the phaseout of the ACTC of 11 × $50 or a total of $550 for each child. Their total ACTC will be $3,600 + $3,000 less the phaseout amount of $1,100 totaling $5,500. The 401(k) deferral reduced their taxes by $39,000 × 22% + ($5,500 – $4,000) = $9,690 savings on their $39,000 tax deferral or almost 25%.

Scenario 3: Jacquie has agreed to split the exemption with her ex-husband Jon, so Jacquie will only have one eligible child for 2021 when they "true up" their Advance Child Tax Credit. Despite great tax planning reducing their MAGI, they will be required to repay the Advance Child Tax Credit for the older child, as that child was "released" to her ex-husband, so they were not eligible for the $1,500 + $550 (threshold excess) of the ACTC.

Advanced Child Tax Credit Phaseout Thresholds

	Age 0–5 Phaseout Begins	Age 0–5 Phaseout Ends	Age 6–17 Phaseout Begins	Age 6–17 Phaseout Ends
Single	$75,000	$107,000*	$75,000	$95,000*
HOH	$112,500	$144,500*	$112,500	$132,500*
MFJ	$150,000	$182,000*	$150,000	$170,000*

Note:

* Upon reaching the phaseout end, the rules of the CTC (IRC Sec. 24) will take over—see following section of the manual.

CHILD TAX CREDIT (CTC) AND CREDIT FOR OTHER DEPENDENTS (ODC) (IRC SEC. 24)

For 2021, after the phaseout rules of the ACTC have been applied, the CTC rules as modified by TCJA will apply. The credit, as modified by TCJA for tax years beginning after December 31, 2017, and before January 1, 2026, continues providing for—

1. Increased the child tax credit (CTC) from $1,000 to $2,000 per qualifying child.
2. Increased the AGI threshold for the credit. [IRC Sec. 24(h)(3)].
3. A non-refundable $500 credit for other nonqualifying dependents referred to as the Other Dependent Tax Credit (ODC) [IRC Sec. 24(h)(7)].

4. Increased the refundable portion of the CTC from $1,000 to $1,400. This amount is adjusted for inflation starting in 2019. For 2021, the refundable portion remains at $1,400. The refundable portion of the credit is referred to as the "Additional Child Tax Credit (ACTC)."

Those taxpayers who exceed the thresholds of the Advance Child Tax Credit may be eligible for the CTC based on the AGI thresholds of the CTC/ODC. MAGI phase-outs begin at—

- Married Filing Joint: $400,000
- Non-Married Filing Joint Filers: $200,000

The credit will be reduced if the taxpayer's modified adjusted gross income (MAGI) [as defined under IRC Sec. 24(b)(1)] is above the above thresholds. The credit is reduced by $50 for each $1,000 of MAGI (or fraction thereof) above the threshold. These thresholds are not indexed for inflation. The end of the phase-out depends on the number of qualifying children. Note that the ACTC is reduced per child.

The CTC and ACTC are not allowed for a qualifying child unless the taxpayer includes the child's name and SSN. A Social Security number must be issued for both the qualifying child and the taxpayer prior to the due date for filing the return.

If the taxpayer's tax liability isn't sufficient to take full advantage of the non-refundable credit, the taxpayer may be entitled to receive the refundable CTC.

For the maximum $2,000 credit, a taxpayer must have at least one qualifying child, as defined under the Section 152(c) rules. Further, a qualifying child must be—

1. Claimed as a dependent of the taxpayer,
2. Under age 17 on the last day of the tax year, and
3. A U.S. citizen, U.S. resident alien or U.S. national.

PLANNING TIP: The child tax credit follows the exemption, and the noncustodial parent may claim the credit by attaching Form 8332 to claim the child.

The Other Dependent Credit (ODC) is a $500 non-refundable credit (per dependent) for any dependents who are not qualifying children under age 17. There is no age limit for the $500 credit, but the tax tests for dependency status must be met. There is no credit unless the name and the identification number of each qualifying dependent is disclosed on the return. Either an SSN or ITIN will meet the requirement. [IRC Sec. 24(e)].

The credit will be reduced if the taxpayer's modified adjusted gross income (MAGI) [as defined under IRC Sec. 24(b)(1)] is above certain thresholds. The credit is reduced by $50 for each $1,000 of MAGI (or fraction thereof) above the threshold. These thresholds are not indexed for inflation. The end of the phase-out depends on the number of qualifying children.

All nonrefundable credits available to a taxpayer must be claimed prior to calculating the refundable portion of the child tax credit.

For military personnel, IRC Sec. 24(d)(1) provides combat pay, which is otherwise excluded from gross income, and may be treated as earned income for purposes of calculating the refundable portion of the child tax credit.

Due diligence requirements for the CTC/ACTC as a result of the PATH Act are identical to the ETIC. For returns required to be filed in 2021(2020 returns) the penalty is $540. For returns required to be filed in 2022 (2021 Returns) the penalty is $545.

EARNED INCOME CREDIT (IRC SEC. 32)

Earned Income Credit

	2021	2020	2019
Earned income credit:			
Earned income (and AGI) must be less than (MFJ):[1]			
No qualifying children	$27,380	$21,710	$21,370
One qualifying child	48,108	47,646	46,884
Two qualifying children	53,865	53,330	52,493
Three or more qualifying children	56,414	56,844	55,952
Maximum amount of credit (all filers except MFS):			
No qualifying children	$1,502	$538	$529
One qualifying child	3,618	3,584	3,526
Two qualifying children	5,980	5,920	5,828
Three or more qualifying children	6,728	6,660	6,557
Investment income limit	$10,000	$3,650	$3,600
Source:	**Rev. Proc. 2020-45**; **Rev. Proc. 2021-23**; P.L. 117-2	**Rev. Proc. 2019-44**	**Rev. Proc. 2018-57**

[1] To get earned income/AGI phase-out amount for all other filers (except MFS), reduce amount shown by: $5,950 ($4,950 if three or more children) in 2021; $5,890 in 2020; and $5,790 ($5,800 if no children) in 2019.

Law Change

As a result of ARPA 2021, there were several significant changes made to eligibility and amounts for EITC for 2021.

1. For those without qualifying children, the law reduced the minimum age for an eligible recipient from 25 to 19.
2. Several IRC Sections were added with statutory definitions allowing those who are not dependents to qualify:
   - *Specified Student* – A person who is a full-time student for at least 5 months during the taxable year.
   - *Qualified Former Foster Youth* – A person who was in foster care after obtaining age 14.
   - *Qualified Homeless Youth* – A person who has certified that they are homeless child, youth or is an unaccompanied youth or in danger of becoming one.

3. Eliminates the maximum eligibility of age 65, allowing those older adults to claim EITC if otherwise eligible.

4. For those taxpayers with no qualifying children, ARPA doubled the allowable credit amount from 7.65% to 15.3% of earned income.

5. ARPA doubled the phase-out percentage for the calculation of EITC from 7.65% to 15.3%

6. The earned income amount for the EITC determination has been doubled from $4,220 to $8,820.

Other Miscellaneous Provisions of ARPA regarding EITC

1. Allows married spouses who file separate returns to claim EITC.

2. Allowed investment income has been increased from $2,200 to $10,000, the $10,000 amount will be indexed annually for inflation.

3. Residents of U.S. territories and possessions are eligible for EITC.

4. ARPA restricted the ability to claim EITC by repealing Section 32(c)(1)(F) of the Code, which enabled an eligible person who has qualifying children (but for whom the taxpayer does not comply with the TIN notification for such children on his or her return) to instead file for the EITC under the rules applicable to individuals without qualifying children.

5. A one-year election allowing those with greater income in 2021 to elect to use the earned income on for 2019. For joint returns the income of the spouses must be combined, when applicable.

OBSERVATION: Due diligence requirements as provided in IRC Sec. 6695 and the associated regulations are very severe and the penalty for failure to adhere to those requirements. Form 8867 – Paid Preparers Due Diligence checklist is an important part of the return. See more detailed information later in this chapter

Under IRC Sec. 32, a refundable credit is available to taxpayers with earned income who meet certain AGI thresholds. The earned income credit (EIC) is computed using the earned income table and worksheet.

The refundable earned income credit (EITC) is intended to provide targeted tax relief for low to moderate-income working taxpayers and is claimed on Schedule EITC. For the 2019 tax year, 25 million workers received EITC totaling $63 billion. This is a reduction of about $2 billion from 2018. (**www.eitc.irs.gov/partner-toolkit/basic-marketing-communication-materials/eitc-fast-facts/eitc-fast-facts**).

The credit is available to certain low- and moderate-income taxpayers regardless of whether they have a qualifying child. If a taxpayer has a qualifying child, Schedule EITC must be completed and attached to Form 1040.

A valid social security number and earned income are necessary to claim the credit for two classes of taxpayers (childless or with one or more qualifying children).

Taxpayers cannot file amended returns to claim the EITC for failure to provide Social Security numbers for a taxpayer and qualifying child. A taxpayer with a qualifying child must have their Social Security numbers by the due date of the tax return to claim the EITC [IRC Sec. 32(m)].

Taxpayers without a qualifying child must meet three tests to claim EITC:

1. The taxpayer's principal place of abode is within the U.S. for more than half of the tax year,

2. The taxpayer (or if married, either the taxpayer or the spouse) must be over age 18 at the end of the year, and

3. The taxpayer(s) are not being claimed as a dependent by another taxpayer for that tax year.

Children must meet the following four tests regarding the definition of a qualifying child in IRC Sec. 152(c):

1. *Relationship:* Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them, and

2. *Age:* Younger than the person claiming the EIC and either (1) under age 19 at year end, (2) under age 24 at year end if a fulltime student, or (3) any age if permanently and totally disabled during the year, and

3. *No Joint Return:* The child did not file a joint return, and

4. *Residency:* The child lived with the taxpayer claiming the EIC, in the United States, and for more than half the year.

Earned income includes wages, tips, net earnings from self-employment (SE), less half of SE tax and certain other qualifying income.

NOTE: U.S. Armed Forces wages may be designated as combat pay by DOD. Under IRC Sec. 112, such income is excludable from taxable income. Military personnel may elect to treat excluded combat pay as earned income for EIC purposes [IRC Sec. 32(c)(2)(B)(vi)]. The election is made by writing the amount of combat pay found in the taxpayers Form W-2, Box 12 (Code Q), on Form 1040 (IRS Publication 596 has more details). For married taxpayers, the election can be made on a per spouse basis. If the election is made, all of the combat pay of the electing party will be treated as earned income.

The following taxpayers will be excluded from the definition of eligible individual, despite meeting the preceding tests:

1. Any individual who is a qualifying child of another taxpayer for any given tax year cannot claim the EIC on his or her own tax return, and

2. Certain nonresident aliens and individuals living abroad who do not choose to have worldwide income subject to U.S. income tax.

3. The "tie-breaker rules" apply for EITC purposes [IRC Sec(s). 32(c)(3)(A) and 152(c)(4)].

PLANNING TIP: EITC programs operate in 29 states and the District of Columbia, in addition to the federal program. The 2020 list can be found at **www.ncsl.org/research/labor-and-employment/earned-income-tax-credits-for-working-families.aspx**.

The EITC is subject to a phase-out calculation determined by the taxpayer's applicable credit percentage, the applicable phase-out percentage, and the larger of the taxpayer's earned income or adjusted gross income (AGI). The table at the beginning of the chapter shows the qualifying earned income and AGI limits, and the maximum dollar amount of the credit for the number of children.

Additional limitations to claiming the EIC include:

1. Individuals having non-qualified income greater than $10,000 for 2021 cannot claim the EITC. Non-Qualified Income is defined by IRC Sec. 32(i)(2) as taxable interest or dividends, tax-exempt interest, gambling income, net income from rents or royalties not derived in the ordinary course of a trade or business, capital gain net income, or net passive income.

CAUTION: There is no phaseout calculation for excess investment income. A taxpayer with $10,000 of disqualified income in 2021 will receive no EITC.

2. Married filing separate taxpayers do not qualify for the EITC under IRC Sec. 32(d).

CAUTION: The IRS can use its math error authority to disallow improper credits for claims made after December 31, 2015 [IRC Sec. 6213(b)]. The IRS has indicated that the ability to deny a credit prior to exam will save an average of $275 per taxpayer. In addition, it will stop an estimated $5.2 billion in improper claims.

PRACTICE TIP: Practitioners should review the latest information at **www.eitc.irs.gov**, where there is also a due diligence training module that qualifies for CPE. The IRS has created an "EITC Assistant" and an EITC tax preparer toolkit that can be found by searching "EITC assistant" at **www.irs.gov**.

CHILD AND DEPENDENT CARE CREDIT AND EXCLUSION [IRC SEC. 129]

The *nonrefundable credit* (IRC Sec. 21) claimed on Form 2441, and the *income exclusion* (IRC Sec. 129) are available to help offset the qualifying expenses incurred for the care of a child, spouse, or other dependent while the taxpayer is gainfully employed, looking for work, or attending school fulltime.

Qualifying expenses include childcare centers, home care, school costs for below the kindergarten level, and day camps (an overnight camp is not a work-related expense).

To claim the credit, a taxpayer must—

1. Have a qualifying individual, which includes—

   a. A qualifying child as defined under IRC Sec. 152(c) who is under age 13 at the end of the year,

   b. A dependent of the taxpayer who is incapable of self-care, or

   c. The spouse of the taxpayer if the spouse is physically or mentally incapable of self-care.

2. Incur household and dependent care expenses to allow the taxpayer (and spouse) to work, attend school fulltime, or look for work,

3. Have earned income or be a nonworking spouse who cannot physically or mentally care for himself or be a fulltime student for at least five months of the year. Disabled or student spouses are deemed to have earned $250 per month for one qualifying person, or $500 per month for two or more qualifying persons,

4. Make payments for household and dependent care expenses to a dependent care center or to an individual—

    a. Whom the taxpayer (or spouse) cannot claim as a dependent, and

    b. Who is not the taxpayer's child under age 19 at the end of the year,

5. Identify the care provider on their income tax return, including social security number or employer identification number, and

6. File a joint return if married, or as HOH if qualified.

A taxpayer claiming an individual as their qualifying relative may not claim the dependent care credit, unless that qualifying relative is physically or mentally disabled (ILM 200812024 and *Matthew Rice v. Comm.*, TC Summary Opinion, 2009-83).

The credit percentage starts at 35% and is reduced 1% for each $2,000 of AGI over $125,000. When the taxpayer's AGI reaches $438,000 the credit will be completely phased out.

The credit percentage is applied to the lesser of—

1. The amount of qualifying child and dependent care expenses, limited to a maximum of $8,000 for one qualifying person or $16,000 for two or more qualifying persons, or

2. The taxpayer's earned income (or spouse's earned income if less). The credit is computed on Form 2441 (Child and Dependent Care Expenses) and carried to line 49 of Schedule 3 of Form 1040.

3. For 2021 the credit is refundable, to the extent the credit exceeds the tax liability the taxpayer will be eligible for the excess amount to be refunded.

As with other credits, no credit is permitted unless the dependent's social security number is included on the return [IRC Sec. 21(e)(10)].

Law Change: Dependent Care Benefit Program

An exclusion is available to certain taxpayers whose employers provide dependent care benefit programs. Dependent care is a plan by which the employer makes payments to a third party or dependent care. For 2021 the maximum exclusion is $10,500 of dependent-care assistance costs annually. For unmarried and married filing separate employees the exclusion amount is $5,250.

The Consolidated Appropriates Act of 2021 added a grace period to spend the larger amounts contributed for 2020 and 2021. It should be noted that the employer was required to amend the IRC Sec. 125 plan to add these additional higher limits and extended payout periods

PLANNING TIP: Any dependent care benefit shown on Form W-2 must be reported on Form 2441, Parts I and III, by showing the childcare provider, address, TIN, and amount paid.

ADOPTION CREDIT AND INCOME EXCLUSION [IRC SEC. 36C OR 137]

	2020	**2021 Rev. Proc 2020-45**	**2022 Rev. Proc. 2021-**
Max Credit Exclusion	$14,300	$14,440	TBD
Special Needs Credit	$14,300	$14,440	TBD
Phaseout – all marital status except MFS	$214,520–$254,520	$216,660–$256,660	TBD
Phaseout – MFS	$0	$0	$0

There are two types of tax incentives for those who adopt (or in some cases, attempt to adopt) a child. There is a tax credit available for all qualifying taxpayers (IRC Sec. 23 re-designated as IRC Sec. 36C). There is also an exclusion (IRC Sec. 137) available for qualifying taxpayers whose employer pays for adoption costs. The non-refundable credit or exclusion is claimed on Form 8839.

The 2021 credit (IRC Sec. 36C) and exclusion (IRC Sec. 137) levels are—

1. The 2021 maximum credit and exclusion is $14,600 The modified adjusted gross income phase-out threshold starts at $216,660 and is completely phased out at $256,660 for single, HOH, and MFJ filers. *There is no credit for MFS filers*.

2. The $14,660 credit for a special-needs adoption is allowed in the year the adoption is final, regardless of whether the taxpayer has qualified adoption expenses.

3. The limit applies separately to the credit and exclusion, you can take both if available.

4. The adoption credit can be carried over for up to five years on a first-in, first-out basis.

5. The credit can be used against both regular tax and AMT.

The credit and exclusion are available to qualified taxpayers for eligible expenses incurred in a qualified adoption (IRC Sec. 36C). Benefit dollar limitations are based on the adoption of each child and are cumulative over all taxable years (not an annual limitation). This includes any amounts paid for qualified adoption expenses in connection with any unsuccessful attempts to adopt an eligible child before the successful final adoption of another child.

The adoption must be of an *eligible child*, which is any child who is—

1. Under the age of 18 at the time of the adoption, or

2. Physically or mentally incapable of caring for himself.

An eligible *special-needs* child must meet two additional criteria:

1. The state has determined the child cannot or should not be returned to the child's parents, and because of certain circumstances (such as ethnic background, age, physical, mental, or emotional handicaps), cannot be placed with adoptive parents without providing adoption assistance, and

2. The child is a citizen or resident of the United States.

A taxpayer must incur qualified adoption expenses, which include—

1. Reasonable and necessary adoption fees, court costs, attorney and accountant fees, travel expenses (including meals and lodging), and other expenses directly related to the legal adoption of an eligible child, and

2. Costs of construction, renovations, alterations or purchases specifically required by the state to meet the needs of the child. To the extent that these expenses result in a credit, the basis of the property must be reduced.

Qualified adoption expenses do not include the following:

1. Expenses incurred in the violation of state or federal law.

2. Expenses incurred in a surrogate parenting arrangement (Notice 97-9) or in the adoption of a spouse's child (IRC Sec. 36C).

3. Expenses reimbursed under an employer program or otherwise.

4. Expenses allowed as a credit or deduction under any other provision of the federal income tax law.

The timing of the deduction for domestic and foreign adoptions varies in the following circumstances:

1. Domestic adoption expenses are deducted in the year after they are incurred unless it is the year of finalization in which case the remaining expenses are taken in the year incurred.

2. Foreign adoption expenses are all deducted in the year of finalization.

Certain items need to be attached to the electronic return or sent via Form 8453 (Notice 2010-66):

1. The child's taxpayer identification number (TIN) or other proof of identity to the tax return. The TIN can be a Social Security number (apply on Form SS-5) or an ITIN/ATIN number (apply on Form W-7 or W-7A).

2. To avoid additional IRS correspondence, taxpayers should provide a written statement explaining each expense and include copies of cancelled checks and receipts.

3. Special-needs adoptions should further include the state's determination of special need designation.

PLANNING TIP—Adoption Taxpayer Identification Number (ATIN): A taxpayer claiming an adoption credit must include (if known) the name, age, and SSN of the child on the return [IRC Sec. 23(f)]. Reg. §301.6109-3 provides procedures for obtaining taxpayer identification numbers (i.e., adoption taxpayer identification number or ATIN) for children who are in the process of being adopted and do not have an SSN or their SSN is unknown. Generally, if the child is a U.S. citizen or resident alien, the taxpayer can apply for an ATIN using Form W-7A (Application for Taxpayer Identification Number for Pending U.S. Adoptions). If the child is not a U.S. citizen or resident alien, the taxpayer should apply instead for an individual taxpayer identification number (ITIN) using Form W-7 (Application for IRS Individual Taxpayer Identification Number).

NOTE: After adopting a child who has previously been assigned a Social Security number, the Social Security Administration will assign a new number if requested, as it is not uncommon for parents who had their parental rights terminated to attempt to fraudulently use the adopted child's original Social Security number.

SAVER'S CREDIT [IRC SEC. 25B]

The credit for retirement savings contributions is $1,000 ($2,000 for MFJ), based on an eligible individual's qualified retirement savings contributions. The nonrefundable credit is claimed on Form 8880.

To claim the credit, a qualifying taxpayer must—

1. Be at least 18 years old at the end of the tax year and not be eligible to be claimed as a dependent by another taxpayer,
2. Not be a full-time student during five or more months of the calendar year, and
3. Not have a modified adjusted gross income (MAGI) that exceeds the following amounts for 2021.

Joint Filers	Heads of Household	Single & MFS*	Credit Rate
$0–$39,500	$0–$29,625	$0–$19,750	50%
$39,501–$43,000	$29,626–$32,250	$19,751–$21,500	20%
$43,301–$66,000	$32,251–$49,500	$21,501–$33,000	10%
Over $66,000	Over $49,500	Over $33,000	0%

Note:

*MFS filers *do not* qualify unless they lived apart for the entire year [IRC Sec. 219(g)(3)(B)(iii)].

Qualified retirement savings contributions include contributions to any employer qualified plan or any type of IRA by the taxpayer.

Effective for tax years beginning after December 22, 2017, and before January 1, 2026, the designated beneficiary of an ABLE account can claim the saver's credit under IRC Sec. 25B for contributions made to an ABLE account. [IRC Sec. 25B(d)(1)]. (See Chapter 6 for more details.)

RESIDENTIAL ENERGY-EFFICIENT PROPERTY CREDIT [IRC SEC. 25D]

Updated Tax Law

The Residential Renewable Energy Efficiency Property (REEP) Credit may be claimed for solar, wind, geothermal, fuel cell equipment through December 31, 2023, [IRC Sec. 25D, as modified and extended by the Consolidated Appropriations Act of 2021]. Taxpayers can claim a REEP tax credit for a percentage of the cost of eligible property (IRC Sec. 25D).

1. 2020–2022: 26%
2. 2023: 22%
3. Post-2023: No credit available

The REEP credit is a nonrefundable personal credit. The credit can be used to offset both regular tax and AMT. However, the credit *is not* available to offset the 3.8% NIIT nor the individual shared responsibility penalty tax for failure to maintain minimum essential health insurance coverage.

Through December 31, 2023, an individual taxpayer will be allowed a tax credit for qualified property at the applicable percentage for—

1. Solar electric property expenditures for generating electricity used in the taxpayer's home. or

DEVELOPMENT: In PLR 201809003, The IRS held that a battery that was integrated into an existing solar energy system was a qualified solar electric property expenditure eligible for the tax credit under IRC Sec 25D.

2. Solar water heating property expenditures for water used inside the home that encompasses at least half of the hot water demands of the home (Solar heaters for swimming pools and hot tubs do not qualify), or
3. Fuel cell property that relies on a renewable resource (usually hydrogen) to generate power for a home. The equipment must generate at least 0.5 kilowatts of power, or
4. Small wind energy property expenditures that generate up to 100 kilowatts of electricity for residential use, and
5. Geothermal heat pump property that meets federal Energy Star guidelines.

PLANNING TIP: See IRC Sec. 25D(d) for definitions of property qualifying for the REEP credit.

Also contained in the Consolidated Appropriations Act of 2021 passed in December 2020 was another extension of the Residential Energy Property Credit which allowed the credit through December 31, 2021. An individual may claim a credit for—

- 10% of the cost of qualified energy efficiency improvements and
- the amount of the residential energy property expenditures paid or incurred by the taxpayer during the taxable year (subject to the overall credit limit of $500).

Qualified energy efficiency improvements include the following qualifying products:

- Energy-efficient exterior windows, doors, and skylights
- Roofs (metal and asphalt) and roof products
- Insulation
- Residential energy property expenditures include the following qualifying products:
- Energy-efficient heating and air conditioning systems
- Water heaters (natural gas, propane, or oil)
- Biomass stoves (qualified biomass fuel property expenditures paid or incurred in taxable years beginning after December 31, 2020, are now part of the residential energy efficient property credit for alternative energy equipment.)

There is a lifetime limit of $500 ($200 for windows). In addition, there are several individual limits for—

- $50 for any advanced main air circulating fan
- $150 for any qualified natural gas, propane, or oil furnace or hot water boiler
- $300 for any item of energy-efficient building property

Unused credits can be carried forward to the next tax year [IRC Sec. 25D(2)(A)].

2020 SUSPENSION OF THE EXCESS ADVANCED PREMIUM TAX CREDIT [IRC SEC. 36B]

LAW CHANGE ALERT: The American Rescue Plan Act of 2021 suspends the requirement that taxpayers increase their tax liability by all or a portion of their excess advance payments of the Premium Tax Credit (excess APTC) for tax year 2020. A taxpayer's excess APTC is the amount by which the taxpayer's advance payments of the Premium Tax Credit (APTC) exceed his or her Premium Tax Credit (PTC).

The IRS recently announced that, for tax year 2020, taxpayers with excess APTC for 2020 are not required to file Form 8962, Premium Tax Credit, to reconcile their APTC with the amount of PTC they may claim for 2020. They should not report an excess advance Premium Tax Credit repayment on 2020 Form 1040 or Form 1040-SR, Schedule 2, Line 2, or file Form 8962.

Eligible taxpayers claiming a net Premium Tax Credit (net PTC) must file Form 8962 when they file their 2020 tax return. If the taxpayer's PTC computed on the return is more than the APTC paid on the taxpayer's behalf during the year, the difference is a net PTC. (See Form 8962 and its instructions for more information.)

Understanding how recent legislative changes for the PTC affect individuals and families and their 2020 tax return is important. The IRS developed this fact sheet to explain what taxpayers need to know about claiming a net PTC and what to do if they have excess APTC for tax year 2020.

Taxpayers who have already filed their 2020 tax return and who have excess APTC do not need to file an amended tax return or contact the IRS. Instead, taxpayers should follow the below procedures:

1. If a taxpayer has excess APTC, filed their return with Form 8962 and it's still being processed: The IRS will reduce the excess advance Premium Tax Credit repayment amount the taxpayer reported on their 2020 Form 1040 or Form 1040-SR, Schedule 2, Line 2, and Line 29 of Form 8962 to zero and process their return. There is no need to contact the IRS. If a taxpayer receives an IRS letter about excess APTC for tax year 2020, they should disregard the letter.

2. If a taxpayer has excess APTC and filed their return without Form 8962: The individual might have received a letter from the IRS. If they have excess APTC for 2020, they should disregard the IRS letter asking for a missing Form 8962. The IRS will continue processing the 2020 return without Form 8962. If the taxpayer didn't get a letter about a missing Form 8962, the IRS will process the 2020 without Form 8962. If they didn't file a Form 8962 but still reported an excess advance Premium Tax Credit repayment amount on their return, the IRS will reduce it to zero and process the return. There is no need to contact the IRS.

3. If a taxpayer paid an excess APTC repayment amount when they filed their return with Form 8962: Individuals in this situation should not file an amended tax return to get a refund of this amount. The IRS is taking steps to reimburse taxpayers who filed Form 8962, reported, and paid an excess advance Premium Tax Credit repayment amount with their 2020 tax return before the recent changes made by the American Rescue Plan Act of 2021. Individuals in this situation should not file an amended return solely to get a refund of this amount. The IRS will provide more details soon.

4. If a taxpayer is claiming net PTC and filed their return without Form 8962: They will receive a letter from the IRS asking for a completed Form 8962. Taxpayers claiming a net PTC must file Form 8962 when they file their 2020 tax return. If they filed a 2020 tax return and claimed a net PTC but did not file Form 8962 with their return, they should respond to the IRS notice they received or will soon receive. The IRS may need more information to process their 2020 return if there's an amount claimed on Form 1040 or 1040-SR, Schedule 3, Line 8. Individuals are eligible for net PTC for 2020 if their PTC for 2020 is more than the APTC paid for health insurance coverage and the coverage of their family members for 2020, or if they are allowed a PTC for 2020 and were not eligible for APTC, or chose not to receive the benefit of APTC, at enrollment in their health plan for 2020.

5. If individuals have net PTC for 2020, they should review and respond to the IRS notice so that the IRS can finish processing their 2020 tax return and, if applicable, issue any refund due.

PREMIUM TAX CREDIT [IRC SEC. 36B]

Taxpayers with modest incomes are eligible for a refundable income tax credit (i.e., the premium tax credit) to help pay for health insurance coverage in a qualified health plan (QHP) obtained in the individual market through an insurance marketplace, either established by a state or the federal government (a federally facilitated marketplace).

The 2021 credits are based on the 2020 federal poverty level (FPL). The following information is for all states except Hawaii and Alaska and is based on family size. These amounts can be found in the instructions to Form 8962, Premium Tax Credit. Visit **www.payingforseniorcare.com/federal-poverty-level** for additional info.

100% of the Federal Poverty Level for 48 Contiguous States and Washington DC

Size of Household	2020 Coverage	2021	2022
1	$12,490	$12,760	$12,880
2	$16,910	$17,240	$17,420
3	$21,330	$21,720	$21,960
4	$25,750	$26,200	$26,500
For each additional person	$4,420	$4,480	$4,540

The Section 36B credit is designed to help those with household incomes between 100% and 400% of the federal poverty level (FPL) who are not eligible for other qualifying coverage, such as Medicare or affordable employer-sponsored health insurance plans.

Eligibility for the credit is determined by the Marketplace based on the taxpayer’s household income and family size.

To be eligible for the credit:

1. The coverage must be purchased through a state or federally facilitated Exchange or Marketplace. An individual is eligible for a credit only for months (i.e., coverage months) that he/she is covered by a Qualified Health Plan (QHP) obtained through the individual market of a government insurance marketplace.

2. The individual must not have been offered affordable minimum essential coverage by their employer.

3. Generally, individuals who are eligible for Medicare, Medicaid, CHIP, or another state or local health benefits program are not eligible for the premium tax credit.

    a. In states that increased the Medicaid threshold, individuals may not qualify for the credit until their income is more than 138% of the FPL for their applicable family size.

b. Lawfully present aliens are treated as being above the federal poverty level for their state regardless of their income level because they are ineligible to receive Medicaid.

4. Married couples must file a joint income tax return to be eligible for the credit. [Reg. §1.36B-2(b)(2)]

PLANNING TIP: Notice 2014-23 allows victims of domestic abuse to still receive the credit by indicating they are unable to file a joint return.

5. The credit is not available to an individual who is a dependent of another taxpayer. [IRC Sec. 36B(c)(1)(D); Reg. §136B-2(b)(3)]

The credit is a refundable credit and will generate a refund if it exceeds the individual's regular income tax, PTC credited to insurance premium and/or alternative minimum tax (AMT) liability.

Individuals can elect to have the calculated credit paid in advance, directly to the insurer. This information can be obtained from Form 1095-A. The advanced PTC (APTC) must be reconciled with the actual credit on the taxpayer's income tax return:

6. Eligibility for an APTC is determined when individual coverage is purchased through an insurance marketplace. For 2021, the eligibility may have been based on the taxpayers' 2019 personal income tax return. The actual credit, however, is based on the final 2021 return.

7. An individual who receives any advanced payments during the year must file the tax return for that year by original due date [Reg. §1.6011-8(a)].

CAUTION/UPDATE: While the APTC helps with the cost of the insurance, the payment also exposes the taxpayer to a potential liability in cases where the advance is greater than the actual credit. Changes in household income, family size, and marital status can greatly impact and change the amount of the monthly credit. For tax year 2020, the ARPA of 2021 eliminated the requirement to repay any excess premium tax credit (IR-2021-84).

The credit is based on the taxpayer's family size and household income. *Family size* is based on the number of properly claimed personal exemptions on the return [Reg. §1.36B-1(d)]. The term family size includes individuals who are not subject to or who are exempt from minimum essential coverage under IRC Sec. 5000A [Reg. §1.36B-1(d)]. *Household income* for the purpose of the premium tax credit is the sum of [IRC Sec. 36B(d)(2); Reg. §1.36B-1(e)]—

1. The individual's modified adjusted gross income (MAGI) and the aggregate MAGI of all other individuals considered for determining family size who are required to file a tax return. Individuals not required to file, but filing to claim a refund, are not included in the calculation.

2. MAGI for this purpose is the adjusted gross income increased by the foreign earned income exclusion, tax-exempt income received or accrued, and that portion of an individual's social security benefits not included in income.

The premium tax credit is the sum of the monthly premium tax credit amounts for a taxpayer's coverage months. [IRC Sec. 36B(b)(1); Reg. §1.36B-3(a)].

Coverage Month

A *coverage month* is any month in which, on the first day of the month, the taxpayer, spouse, or any dependent is covered by a QHP offered through the individual market of the government insurance marketplace and the premium for that month is paid by the taxpayer [IRC Sec. 36B(c)(2); Reg. §1.36B-3(c)].

A coverage month does not include any month the individual was eligible to enroll in an affordable employer plan meeting the minimum essential coverage requirement. If an employer plan fails to meet either the minimum essential coverage or affordability criteria, the individual would be eligible for the credit if they decline the coverage and enroll in a plan offered by the marketplace.

If the coverage is terminated during the month and the insurer reduces or refunds a portion of the premium, the monthly premium assistance amount is prorated based on the number of days of actual enrollment.

Applicable percentage is used to determine the taxpayer's expected contribution to the premium. The percentage comes directly from IRC Sec. 36B(b)(2)(B) and is indexed annually. The percentages can be found at the end of the instructions to form 8962, Premium Tax Credit.

The credit is based on the lesser of—

1. Actual premiums paid, or
2. The benchmark premium, less the household income, times the applicable percentage.

The *benchmark premium* is the second lowest silver plan available at the marketplace.

The *applicable percentage* is based on the taxpayer's household income as a percentage of the federal poverty line.

	Rev. Proc. 2021-23		**Rev. Proc. 2021-23**	
	2021 Returns		**2022 Returns**	
Household income percentage of Federal poverty line:	**Initial percentage**	**Final percentage**	**Initial percentage**	**Final percentage**
Less than 133%	0.00%	0.00%	0.00%	0.00%
At least 133% but less than 150%	0.00%	0.00%	0.00%	0.00%
At least 150% but less than 200%	0.00%	2.00%	0.00%	2.00%
At least 200% but less than 250%	2.00%	4.00%	2.00%	4.00%
At least 250% but less than 300%	4.00%	6.00%	4.00%	6.00%
At least 300% but not more than 400%	6.00%	8.50%	6.00%	8.50%
400% or higher	8.50%	8.50%	8.50%	8.50%

EXAMPLE: Determining Applicable Percentage

Melanie's household income is at 275% of the federal poverty line. Therefore, her income is halfway between 250% and 300% of the FPL. Her applicable percentage is calculated as 5.00% [50% × (6.00% – 4.00%) + 4.00%].

EXAMPLE: Determining Premium Tax Credit

Tom, a single individual living in Oregon, has household income for purposes of the premium tax credit of $31,225. Assuming the SLCSP in Oregon costs $4,800 a year (i.e., $400 per month) for single coverage and Tom's income is 250% of the FPL, Tom's applicable percentage (i.e., premium percentage) is 4.00%, and his contribution (affordable premium amount) is $1,249.00 (4.00% × $31,225), or $104.08 per month. Tom's premium tax credit for the year is $3,551.00 ($4,800.00 – 1,249.00) or $295.92 per month.

Tom can elect to have the APTC of $295.92 paid monthly directly to the insurer. By doing this, Tom only has to pay his affordable premium amount ($104.08) to the insurer each month. The insurer receives the total $400 in premiums each month.

Reconciling the Credit with Advance Payments

The credit is reconciled when the return is filed. Accordingly, those who were advanced less than the actual credit will be entitled to a refund. Those with excess PTC advances will have to repay the excess.

The repayment is limited for those who receive an excess advance but whose household income remains below 400% of the FPL. The following chart indicates the maximum credit repayment based on income. These amounts are indexed for inflation (Rev.Proc. 2021-23) and rounded down to the nearest $50:

Household income percentage of Federal poverty line	Single Filers	Married, Surviving Spouse, and HOH
Less than 200%	$325	$650
At least 200% but less than 300%	$800	$1,600
At least 300% but less than 400%	$1,350	$2,700

In the event a taxpayer's household income is greater than or equal to 400% of the FLP, the entire excess must be repaid without limitation.

Taxpayers that must repay some or all of the credit may also be subject to an estimated tax penalty [IRC Sec. 6654(a)] and/or a failure-to-pay penalty [IRC Sec. 6651(a)(2)]. Unlike the shared responsibility penalty, the IRS can use all the weapons in its arsenal to collect the liability.

HEALTH COVERAGE TAX CREDIT

The Health Coverage Tax Credit (HCTC), a Federal tax credit administered by the IRS, was extended by ARPA 2021 for all months beginning in 2021**.** This means eligible individuals can receive a tax credit to offset the cost of their monthly health insurance premiums for 2021 if they have qualified health coverage for the HCTC. A health plan offered through the Health Insurance Marketplace is not qualified coverage for the HCTC.

A letter was sent in October 2020 advising participants in the HCTC Advance Monthly Program to seek alternative insurance options due to the impending expiration of the HCTC at the end of 2020. All participants were later removed from the HCTC Advance Monthly Program.

With the extension of the HCTC for 2021, participants may be able to work with their vendors or providers to be placed back on health coverage that qualifies for the HCTC and either re-enroll in the HCTC Advance Monthly Program or claim the HCTC on their annual Federal income tax return filed next year.

The IRS expects to begin processing Forms 13441-A on January 15, 2021; forms received prior to this date were held for processing.

FORM 8867, PAID PREPARER’S DUE DILIGENCE CHECKLIST

IRC Sec. 6695(g) places additional due diligence requirements on practitioners when preparing returns with certain refundable credits and Head of Household filing status.

PRACTICE ALERT: The IRS has estimated that of all EITC filings, 22%–26% of claims that are filed for EITC are fraudulent. This amounts to an overpayment of between 29% and 39% percent of all EITC dollars totaling $14 billion–$19 billion, annually. The IRS and congressional response to this problem has been to heighten due diligence requirements for paid preparers. With a declining number of paid preparer returns, less than 40% of individual returns are now filed by professionals, many practitioner organizations are questioning that strategy, as fraud numbers reflect no significant decline.

A tax return preparer of any return or claim for refund of the listed credits or HOH filing status who fails to comply with due diligence requirements (Reg. §1.6695-2) is subject to penalty with regard to—

1. Determination for the eligibility and the amount of earned income tax credit (EITC), or

2. Eligibility to file as a head of household (HOH), or

3. The applicability and allowance of the child tax credit (CTC) and/or an additional child tax credit (ACTC), or

4. An American opportunity tax credit (AOTC).

A separate penalty applies to each listed credit/filing status for which the due diligence requirements are not satisfied and for which an exception to the penalty does not apply. [IRC Sec. 6695(g); Reg. §1.6695-2(a)]

Reg. §1.6695-2 requires preparers to submit Form 8867, Paid Preparer’s Due Diligence Checklist, with tax returns claiming the listed credits/filing status. Every preparer who interviews or obtains information from the taxpayer about their credits/HOH eligibility must individually attest to and sign Form 8867.

The preparer is required to make reasonable inquiries if the information received appears to be incorrect, inconsistent, or incomplete. Preparers should keep copies of any documents the client provides to prove eligibility, such as a birth certificate, social security card, or driver's license. Proof of the interview, copies of inquiries, and documents should be retained for three years from the later of the—

1. due date without extension,

2. date filed,

3. date presented to the taxpayer for signature, or

4. date the preparer submitted the credits/filing status to the return signer.

The IRS issued Reg. §1.6695-2 outlining how a practitioner can comply with the knowledge rules. The regulation states "knowledge can be obtained by interviewing the client supported with documents or by statements from third parties" (supporting documents are not required of third-party statements).

The regulations state that statements made by the taxpayer should generally be verified with documentation (see the Foxx case later in this chapter).

The IRS and TIGTA have issued several statements/advisories regarding ETIC and other refundable credits. Several court cases have also held practitioners and taxpayers to higher standards of care in preparing returns containing these credits. Some of the more pertinent developments are:

- The IRS is required to withhold tax return refunds until February 15 if the return includes EIC and/or ACTC.

- In a 2017 report, TIGTA encouraged the IRS to be more proactive in the use of third-party documents to identify potentially improper refundable credits and/or withholding. The result of that determination is an increased number of returns subjected to the Integrity & Verification Operations (IVO). As a result of this compliance project, many returns are being held until IRS has an opportunity to review wage and withholding documents.

OBSERVATION: When a taxpayer's return becomes ensnarled by the (Integrity and Verification Operation (IVO), at a minimum it will take at least a month to clear. The hold on a return most often occurs when the IRS cannot identify a copy of a wage or withholding document claimed on the return or it suspects the return is fraudulent. See additional information in Chapter 19 (Identity Theft and Refund Fraud).

In *Foxx* [119 AFTR 2d 2017-695 (130 Fed. Cl. 415)], a preparer was being assessed a preparer penalty for improperly claiming self-employment income to qualify the taxpayer the EITC. The taxpayer claimed the practitioner developed a scheme for showing false income. The court said it did not matter if the taxpayer's claim was true or false. During the examination of the records the preparer did not have or failed to request proper documentation or use due diligence. Pursuant to IRC Sec. 6694(b) that failure was considered to be willful and/or reckless. In the court's final analysis of the matter, it said:

1. The practitioner recklessly disregarded the tax preparer rules and regulations under Reg. §1.6695-2T.

2. The practitioner was required to perform due diligence but failed to do so.

3. The practitioner failed to examine bank statements, business expense receipts or business ledgers. He relied solely on the taxpayer's business license and two pages of notes written by the practitioner outlining the expenses associated with the business.

During exam, the IRS disallowed 100% of the SE income of a taxpayer who failed to maintain any kind of contemporaneous records regarding her business income and expenses. The court (Lopez v. Comm., TC Summary Opinion 2017-16) did find partially for the taxpayer allowing some of her business income. In its closing statement the court noted that the failure by the taxpayer to maintain adequate records could support a finding of negligence for purposes of the accuracy related penalty under IRC Sec. 6662(a), but due to their reliance on a practitioner chose to not assess the penalty.

WARNING: Preparers and firms that do not comply with the due diligence rules will be subject to a $540 penalty per failure per return filed in 2021 and $545 per return filed in 2022 [IRC Sec. 6695(g)]. This penalty is inflation adjusted annually, the penalty for returns filed in 2020 was $535. [Rev. Proc. 2018-57]. Since the penalty is based on a per failure per return there is a potential for a due diligence penalty equal to the number of returns times $540/$545 filed in that year.

CAUTION: The IRS is requesting an increasing number of documents to establish EITC claims. When requesting supporting documents, the IRS will often use Form 886-H-DEP—particularly for dependency issues. This does give a window into what documents the IRS prefers/wants to verify these types of relationships

If You Are:	Then please send photocopies of the following documents:
Divorced, legally separated, or living apart from the other parent of the child claimed on your return.	Entire divorce decree, separation agreement, decree of separate maintenance. If you are living apart from the child's other parent, but you are not divorced or legally separated, send proof that you did not live with the child's other parent for the last six months of the year. Current custody order, completed *Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents* or a similar statement as applicable for 2019. You may need to send more than one document.
If the Person Is:	**Then please send photocopies of the following documents:**
Your qualifying child	Birth certificates or other official documents of birth, marriage certificates, letter from an authorized adoption agency, letter from the authorized placement agency, or applicable court document that verify your relationship to the child *(send these documents only for a qualifying child who is not your natural or adopted child).* To show both you and your child lived together at the same address or addresses for more than half of 2019, send either: • School, medical, daycare, or social service records. • A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. *(If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.)* **You may need to send more than one document** to show that the child lived with you for more than half of the year.
If the Person Is:	**Then please send photocopies of the following documents:**
Your qualifying relative	Birth and marriage certificates that verify your relationship to the qualifying relative. If you claim a non-blood related person as a qualifying relative, send proof the person has lived in your home for the entire 12 months of the year. To show both of you lived together at the same address or addresses for all of 2019, send either: • School, medical, daycare, or social service records. • A letter on the official letterhead from a school, medical provider, social service agency, or place of worship that shows names, common address and dates. *(If you send a letter from a relative who provides your daycare, you MUST send at least one additional letter that provides proof.)*

SUMMARY: BUSINESS CREDITS

The Code provides income tax credits intended to subsidize, and sometimes to encourage, various business activities. All these business credits are component credits of a single credit called the *general business credit* (GBC). The GBC generally is only allowed against the income tax (excluding the tax on self-employment income) for a particular tax year and is subject to an annual limitation based on tax liabilities. However, a taxpayer may use certain specified credits to offset all or part of the alternative minimum tax (AMT).

A General Listing of Business-Related Credits (www.irs.gov/businesses/small-businesses-self-employed/business-tax-credits)		
Investment Credit – Form 3468	American Samoa Economic Development Credit – Form 5735	**Work Opportunity Credit – Form 5884
Alcohol and Cellulosic Biofuels Fuels Credit – Form 6478	Credit for Increasing Research Activities – Form 6765	Low Income Housing Credit – Form 8586
Orphan Drug Credit - Form 8820	Disabled Access Credit – Form 8826	**Qualified Plug-In Electric and Electric Vehicle – Form 8834
Renewable Electricity, Refined Coal, and Indian Coal – Form 8835	Empowerment Zone Employment Credit – Form 8844	Indian Employment Credit – Form 8845
**Credit for SS and Med. Tax Paid on Emp. Tips – Form 8846	Biodiesel and Renewable Diesel Fuels Credit – Form 8864	New Markets Credit – Form 8874
*Credit for Small Employer Pension Plan Startup Costs – Form 8881	Credit for Employer Provided Childcare Facilities – Form 8882	Low Sulfur Diesel Fuel Production Credit – Form 8896
Qualified Railroad Track Maintenance – Form 8900	Distilled Spirits Credit – Form 8906	**Energy Efficient Home Credit – Form 8908
Alternative Motor Vehicle Credit – Form 8910	Mine Rescue Team Training Credit – Form 8923	Credit for Employer Differential Wage Payments – Form 8932
Carbon Dioxide Sequestration Credit – Form 8933	Qualified Plug-In Electric Drive Motor Vehicle – Form 8936	Credit for Small Employer Health Insurance – Form 8941
*Employer Credit for Paid Family and Medical Leave – Form 8994	*Covered Elsewhere in this Manual	**Covered in this Chapter

A GBC may generally be carried back one year and forward 20 years. A taxpayer must file Form 3800, General Business Credit, to claim any of the GBCs.

PLANNING TIP: A taxpayer should always start out by using the applicable form for the specific credit being claimed. If that credit is the only one (of the credits comprising the general business credit) with which the taxpayer is concerned and there are no carrybacks or carryovers of any of the component credits, Form 3800 is not needed at all. In any event, even if Form 3800 is needed, the completed form for the specific credit claimed is also needed.

FAMILIES FIRST CORONAVIRUS RESPONSE ACT (FFCRA) CREDITS TO EMPLOYERS

The Families First Coronavirus Response Act (P.L. 116-127, FFCRA), was intended to ease the economic consequences stemming from the novel coronavirus disease (COVID-19) outbreak, required employers to provide COVID-19 family leave and sick leave to employees, and provides tax credits to employers for providing the leave.

Eligibility for Leave

The EPSLA or EFPSLA requires Eligible Employers to provide employees with paid sick leave if the employee is unable to work (including telework) due to any of the following:

1. The employee is under a Federal, State, or local quarantine or isolation order related to COVID-19; or

2. The employee has been advised by a health care provider to self-quarantine due to concerns related to COVID-19; or

3. The employee is experiencing symptoms of COVID-19 and seeking a medical diagnosis; or

4. The employee is caring for an individual who is subject to a Federal, State, or local quarantine or isolation order related to COVID-19, or has been advised by a health care provider to self-quarantine due to concerns related to COVID-19; or

5. The employee is caring for the child of such employee if the school or place of care of the child has been closed, or the childcare provider of such child is unavailable, due to COVID-19 precautions; or

6. The employee is experiencing any other substantially similar condition specified by the U.S. Department of Health and Human Services.

Emergency Paid Sick Leave Act (EPSLA)

The EPSLA provides up to 80 hours of employee paid sick leave.

1. Eligible full-time employees may receive up to 80 hours (two weeks) of paid emergency sick leave (up to $511 per day, up to a maximum total of $5,110) when the employee is subject to a quarantine or isolation, is experiencing symptoms of COVID-19 or is seeking a diagnosis and/or treatment.

2. Part-time employees are entitled to paid sick leave for the typical number of hours worked in a two-week period (up to $511 per day, up to a maximum total of $5,110)

Emergency Family Paid Sick Leave Act (EFPSLA)

The EFPSLA provides up to 50 days of paid leave. The first 10 days of leave may be unpaid followed by 10 weeks of paid leave.

The rate of pay will be ⅔ of an employee's regular rate of pay and the number of hours the employee would otherwise be normally scheduled to work, not to exceed $200 per day and $10,000 in the aggregate. Paid family leave may be taken by an employee to care for a family member or child due to school closure or other COVID-19-related reason.

The self-employed taxpayer is eligible for an equivalent EPSLA and EFPSLA credit:

1. Qualified sick leave equivalent amount
2. Qualified family leave equivalent amount

Calculating average daily self-employment income for an individual who is self- employed. Average daily self-employment income is an amount equal to the net earnings from self-employment for the prior taxable year divided by 260. A taxpayer's net earnings from self-employment are based on the gross income that he or she derives from the taxpayer's trade or business minus ordinary and necessary trade or business expenses.

To calculate the qualified sick leave equivalent:

1. The number of days during the taxable year that the individual cannot perform services in the applicable trade or business,
2. Multiplied by the lesser of $200 or 67% of the *average daily self-employment income* of the individual for the taxable year.
3. In either case, the maximum number of days a self-employed individual may take into account when determining the qualified sick leave equivalent amount is 10.

The qualified family leave equivalent is—

1. The number of days (up to 50) during the taxable year that the self-employed individual cannot perform services for which that individual would be entitled to paid family leave (if the individual were employed by an Eligible Employer other than himself or herself),
2. Multiplied by the lesser of two amounts:
   a. $200, or
   b. 67% of the average daily self-employment income of the individual for the taxable year.

The self-employed individual equivalent amounts most likely will be reported on Form 1040, Schedule 3, Part II.

The total credit amount for the employer will be either a refundable credit on Form 94x or a refund request on Form 7202.

To calculate the employer credit:

1. The gross payments to the employee as a result of the EPSLA or EFPSLA, plus

2. The cost of the employer's share of Medicare (1.45%) (Employer payments under EPSLA or EFPSLA are not subject to the employer share of social security), plus

3. The portion of the employer's qualified health care expenses.

Additional detailed information can be found in Chapter 3 of Gear Up's *Business Entities* manual, as eligibility for this credit was extended to 2021.

The EPSLA and EFPSLA are regulated by the DOL. Answers to questions can be found at **www.dol.gov/agencies/whd/pandemic/ffcra-questions**. The requirement to provide this coverage was discontinued on 12/31/2020 but the credit was extended. (See Chapter 3 of Gear Up's *Business Entities* manual.)

EMPLOYER RETENTION CREDIT (ERC) (IRC SEC. 45S)

The CARES Act provides a refundable payroll tax credit for wages paid by *Eligible Employers* to certain employees during the COVID-19 crisis. *Eligible Employers* include private-sector businesses and tax-exempt organizations whose operations have been fully or partially suspended as a result of a government order limiting commerce, travel, or group meetings, or

The credit is also provided to employers who have experienced a greater than 50% reduction in quarterly receipts (sometimes referred to as a "significant decline in gross receipts"), measured on a year-over-year basis.

It is important to note that initially recipients of the Payroll Protection Program were not eligible for this credit. However, that limitation was removed as a result of the Consolidated Appropriations Act of 2021 signed by the president in December of 2020.

Additional information on the ERC can be found in Chapter 3 of Gear Up's *Business Entities* manual.

WORK OPPORTUNITY CREDIT

The Section 51 Work Opportunity Tax Credit (WOTC) is available to employers of persons who fall into one of the designated target groups (generally, economically, or physically disadvantaged persons), including qualified veterans, [IRC Sec. 51(c)(4)].

The credit is claimed on Form 5884 (Work Opportunity Credit).

An employee must submit Form 8850 (Pre-Screening Notice and Certification Request for the Work Opportunity Credit) to the employer showing how the employee qualifies for the credit.

The WOTC equals 40% of eligible wages paid up to $6,000 per employee during the first year of employment. The amounts for summer youth program are 40% up to first $3,000 paid. For more information see **www.irs.gov/businesses/small-businesses-self-employed/work-opportunity-tax-credit**.

The Consolidated Appropriation Act, 2021 (Section 113 of Division EE P.L. 116-260) authorized the extension of the Work Opportunity Tax Credit (WOTC) until December 31, 2025.

SECTION 47 REHABILITATION INVESTMENT CREDIT

The Section 47 rehabilitation investment credit is available to owners of rehabilitated older buildings used for nonresidential purposes or certified historic structures used for residential or nonresidential purposes. The credit is based on 20% of the cost of rehabilitation of qualifying historic buildings. The TCJA requires taxpayers to take the credit over 5 years and eliminated the 10% credit on rehabilitated pre-1936 buildings.

The credit requires advance certification of the structure. For more information, visit **www.irs.gov/businesses/small-businesses-self-employed/rehabilitation-tax-credit-real-estate-tax-tips**.

DISABLED ACCESS CREDIT

The Section 44 disabled access credit is available to eligible small businesses that incur expenditures to facilitate the access and use of the business facilities by disabled individuals. The credit is claimed on Form 8826 (Disabled Access Credit).

To qualify as an eligible small business, a business must make the election to claim the credit (by filing Form 8826) and have either—

1. Gross receipts for the prior year of $1 million or less, or

2. Employed 30 or fewer full-time employees during the prior year.

The credit is equal to 50% of the eligible access expenditures for that year that exceed $250 but do not exceed $10,250. The maximum credit is $5,000 for any one year.

EMPLOYER SOCIAL SECURITY TIP CREDIT

The Section 45B employer social security credit is available to food and beverage establishments for social security taxes paid on tip income in excess of minimum wages.

Generally, the credit equals the amount of employer social security and Medicare taxes paid or incurred by the employer on tips received by the employee. However, employers cannot claim the credit for taxes on any tips that are used to meet the federal minimum wage rate in effect on January 1, 2007, $5.15 an hour.

The credit is claimed on Form 8846 (Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips).

EXAMPLE: Determining the Employer Social Security Tip Credit

The Chuck Wagon has one food server, Sara, who worked 300 hours during the year. Sarah was paid $3 an hour and reported $3,000 in tips on which the Chuck Wagon paid its share of the FICA/MEDICARE Taxes. To calculate the tip credit on Sara, the total income of $3,900 (300 hours × $3.00 per hour plus $3,000 in tips) is compared to the total minimum wage based on the 2007 minimum tax rate of $5.15 per hour. The total minimum wage would have been $1,545 (300 hours × $5.15 per hour) leaving an excess of $2,355. The tip credit will be based on the lesser of the actual tips of $3,000 or the excess of $2,355. Accordingly, the tip credit will be $180 ($2,355 × 7.65%).

BUSINESS ENERGY CREDIT

The Section 48 Business Energy Credit is designed to encourage the production and use of, or conversion to, business equipment using energy sources other than oil or gas as a primary source of industrial or agricultural energy

The energy credit allows business taxpayers to claim a nonrefundable tax credit, a percentage of the cost for energy-efficient property placed in service such as solar panels to generate electricity or hot water heat or process heat [IRC Sec. 48(a)(2)(A)]. The credit is part of the investment credit and is claimed on Form 3468 (Investment Credit). The amount of the credit is being reduced over the next several years.

1. 2020: 26%
2. 2021: 22%
3. 2022: No credit available.

If construction begins before January 1, 2022, and the property is not placed in service before January 1, 2024, the energy percentage is only 10% [IRC Sec. 48(a)(6)].

Solar energy property includes storage devices, power conditioning equipment, transfer equipment, and property solely related to the functioning of these items. However, such equipment does not include transmission equipment. Pipes and ducts used exclusively to carry energy derived from solar energy are solar energy equipment. Equipment that uses solar energy beyond the distribution stage qualifies only if it is specially adapted to use solar energy [Reg. §1.48-9(d)].

ALTERNATIVE FUEL REFUELING PROPERTY

A taxpayer can claim a 30% credit for the cost of installing non-hydrogen alternative vehicle refueling property for use in the taxpayer's trade or business (up to $30,000 maximum per year per location) or installed at the taxpayer's principal residence (up to $1,000 per year per location).

ENERGY EFFICIENT HOMES CREDIT

A credit for manufacturers of energy-efficient residential homes. An eligible contractor may claim a tax credit of $1,000 or $2,000 for the construction or manufacture of a new energy efficient home that meets qualifying criteria.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 596, *Earned Income Credit*
- IRS Pub. 972, *Child Tax Credit*
- IRS Pub. 17, *Your Federal Income Tax*
- Instructions to IRS Form 3800, General Business Credit.
- Instructions to IRS business tax credit forms (provided within the chapter's text).
- **www.irs.gov/businesses/small-businesses-self-employed/business-tax-credits**

CHAPTER 14: SALE OF RESIDENCE

Learning Objectives

Completion of this chapter will enable participants to—

- Determine if the exclusion or the reduced exclusion applies.
- Apply rules for nonqualified use of a principal residence.
- Analyze the proper tax treatment for "short sales."
- Evaluate tax and non-tax consequences of reverse mortgages.

WHAT'S NEW

1. An updated chart to apply settlement costs on a closing statement to the transaction.
2. Updated analysis of fees for reverse mortgages.

DEFINITION OF *RESIDENCE*

The definition of *residence* includes a house, townhome, condominium, houseboat, house trailer, and a motor home. A tenant-stockholder who lives in a cooperative housing corporation can also qualify [Rev. Rul. 64-31; IRC Sec. 121(d)(4)].

> **NOTE:** A residence does not include personal property, such as patio furniture, a pool table, etc., which according to applicable local law is not a fixture.

The definition of *principal residence* is found in former IRC Sec. 1034 and Reg. §1.1034-1(c)(3)(i):

1. A taxpayer must have a legal interest in the property for it to be treated as his residence. For example, a home in which the taxpayer's daughter held the legal title would not be a residence of the taxpayer. (Rev. Rul. 55-37)
2. To qualify as a residence, the dwelling unit must have cooking, sleeping, and toilet facilities.
3. Land, under certain circumstances, may be included in the residence. The building lot will qualify. Vacant land may also qualify if four conditions are met [Reg. §1.121-1(b)(3)(i)]:
    a. The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence,
    b. The taxpayer owned and used the vacant land as part of the taxpayer's principal residence,

c. The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of IRC Sec. 121 within two years before or two years after the date of the sale or exchange of the vacant land, and

d. The requirements of IRC Sec. 121 have otherwise been met with respect to the vacant land.

EXAMPLE: Treatment of gain on sale of residence

In 2010, Mi-Casa buys a house and one acre that he uses as his principal residence. In 2012, he buys nine acres adjacent to his house at a foreclosure sale and uses the vacant land as part of his principal residence. After re-dividing the property, Mi-Casa sells the house and five acres in 2020, and the remaining five acres in 2021. He sells the house and five acres at a $25,000 loss and sells the other five acres at a gain of $100,000. He may exclude the net $75,000 gain from the two sales.

DEFINITION OF *PRINCIPAL RESIDENCE*

Whether property is used by the taxpayers as their residence, and whether property is used by the taxpayers as their principal residence depends on the facts and circumstances of each case.

PLANNING TIP: A taxpayer's principal residence is not necessarily the same as the taxpayer's tax home for trade or business expense purposes.

COURT CASE: Home is where the heart is, but not necessarily for the IRS. In *Brown*, the taxpayer was a consultant and a resident of Atlanta, GA. Mr. Brown was audited and for the year in question, he spent four days a week working in New Jersey. Usually, he had several clients and worked on several projects. In the audit year, unfortunately, he had no other work assignments other than in New Jersey. He tried to deduct travel expenses to New Jersey, and then he tried to deduct travel *from* New Jersey. He lost on both parts and the Court upheld the IRS's position that the *tax home* is where the paycheck is. (*Brown v. Comm.*,15 AFTR2d 2020-1486)

The IRS will not issue letter rulings or determination letters on whether a property qualifies as a taxpayer's principal residence because of the inherently factual nature of the problems involved (Rev. Proc. 2020-3).

In the case of a taxpayer using more than one property as a residence, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. Interestingly, many taxpayers living in areas hard hit by COVID-19 have shifted to living in vacation homes in less exposed areas.

Reg. §1.121-1(b)(2) includes a list of six factors that are relevant in identifying a property as a taxpayer's principal residence:

1. The taxpayer's place of employment;

2. The principal place of abode of the taxpayer's family members;

3. The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;

4. The taxpayer's mailing address for bills and correspondence;
5. The location of the taxpayer's banks; and
6. The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

PLANNING TIP: If taxpayers have multiple residences where they purchase health insurance will be the deciding factor.

COURT CASES: In Stolk, a taxpayer resided with his family in a Manhattan penthouse apartment during the week. On the weekends, he and his family would go to a country house in Chappaqua, NY. The taxpayer sold the country house and purchased another home in Esmont, VA. The taxpayer still resided in the Manhattan apartment and only occupied the Esmont home on weekends and holidays, which made the Manhattan apartment the principal residence. Thus, gain on the sale of the Chappaqua house was taxed [*William C. Stolk v. Comm.*, 40 TC 345 (1963), aff'd, 326 F.2d 760 (2nd Cir. 1964)].

In *Guinan*, the taxpayers purchased a residence in Wisconsin in March 1993 and sold it in September 1998. From 1993 to 1996, they also owned a home in Georgia. The Georgia property was sold in 1996, at which time the taxpayers purchased a residence in Arizona. During the five years preceding the sale of the Wisconsin property, the taxpayers occupied the Wisconsin property for a total of 847 days, the Georgia property for 563 days and the Arizona property for 375 days. The taxpayers were denied an exclusion on the sale of the Wisconsin property because they did not spend the requisite number of days in the Wisconsin home on a year-by-year basis [*James M. Guinan v. U.S.*, 91 AFTR 2d 2003-2174 (D.C. Ariz. 2003)].

COMPUTATION OF GAIN OR LOSS

IRC Sec. 1001(a) provides the following formula in connection with property transactions:

Amount Realized – Adjusted Basis = Gain or Loss

The *Amount Realized* is the sum of any money received, plus the fair market value (FMV) of any other property received. It includes any liability on the property that has been sold if the buyer assumes the mortgage or the property is sold subject to the mortgage. Although a legal distinction exists between the direct assumption of a mortgage and the purchasing of property subject to a mortgage, the tax consequences in calculating the amount realized is the same [*Crane v. Comm.*, 331 U.S. 1 (1947)].

The *realized amount* is equal to the outstanding balance of the liability (including a nonrecourse mortgage) even if the liability balance exceeds the FMV of the property [*Comm. v. Tufts*, 52 AFTR 2d 83-5759 (712 F.2D 199) (CA4) (1983)].

In calculating the amount realized, selling expenses such as advertising, commissions, and legal fees relating to the sale are deducted. *Amount realized* also includes any real property taxes treated as imposed on the seller that are actually paid by the buyer. [IRC Sec. 1001(b) and Reg. §1.1001-1(b)]. The reason for including these taxes in the amount realized is that by paying the taxes, the purchaser is paying an additional amount to the seller of the property. However, this also gives rise to a potential deduction by the seller, as the taxes are deemed to be paid by the seller.

Adjusted Basis is the property's original basis adjusted to the date of the sale [IRC Sec. 1011(a) and Reg. §1.1011-1], and is determined as follows:

Original Cost + Capital Additions – Capital Recoveries = Adjusted Basis

Original cost includes the amount paid for the property in cash or other property [IRC Sec. 1012 and Reg. §1.1012-1(a)]. Any liability on property that is assumed by the buyer is also included in the buyer's original cost of the property. The same rule applies if property is acquired subject to a liability:

1. If inherited, residence basis is FMV at decedent's date of death.

2. If received as a gift, residence basis is donor's basis (when calculating a gain on the sale of the home).

3. If received in a divorce, basis is the adjusted basis for the spouse giving up his half, added to the adjusted basis of the spouse keeping the house.

Capital additions include the cost of capital improvements and betterments made to the property by the taxpayer. Amounts representing real property taxes treated as imposed on the seller but paid or assumed by the buyer are part of the cost of the property [IRC Sec. 1001(b) and Regs. 1.1001-1(b)(2) and 1.1012-1(b)].

Capital recoveries include depreciation and cost recovery allowances, casualties or thefts and easements:

1. A casualty or theft may result in the reduction of the adjusted basis of the property. The adjusted basis is reduced by the amount of the deductible loss as well as by the amount of insurance proceeds received. However, the receipt of insurance proceeds may result in a recognized gain rather than a deductible loss. The gain increases the adjusted basis of the property. [Reg. §1.1016-6(a)].

LAW CHANGE ALERT: The TCJA suspended the deduction for personal casualty and theft losses, except for casualty losses incurred in a federally declared disaster, for tax years 2018–2025.

2. An *easement* is the legal right to use the land of another person for a special purpose. If the taxpayer does not retain any right to the use of the land, then the entire basis is assigned to the easement. In contrast, an allocation of some of the basis to the easement may be required if the use of the land is only partially restricted.

COURT CASE: In *Wickersham*, the taxpayers owned land on which they had their principal residence and also ran a towing business. The county wanted to put a road through their parcel of land. After the county threatened to condemn the front portion of the property, the taxpayers eventually sold the county a permanent easement for $131,000. The Tax Court concluded that the easement was a sale of a property interest for $131,000. However, the portion of the profit that is allocated to the residential component of their mixed-use property could be excluded as a gain from selling their principal residence (*Lawrence L. Wickersham v. Comm.*, TC Memo 2011-178).

3. Energy credits reduce residence basis. Many Taxpayers tend to ignore this.

NOTE: The basis of a principal residence that was acquired prior to May 7, 1997, may still be reduced by any gain from the sale of the old residence that was realized, but not recognized due to the provisions of former IRC Sec. 1034 [Reg. §1.1034-1(a)].

SETTLEMENT COSTS

Settlement costs from the sale or purchase of a residence can be basis adjustments, nondeductible expenses, or deductible expenses in the year of sale or the year of purchase.

The following chart summarizes the differences:

Settlement Costs	Seller	Buyer
Assessments such as HOA, condo dues	Not Deductible	Not Deductible
Attorney fees related to obtaining or selling property	Selling Expense	Increase Basis
Closing costs related to the loan, which includes attorney fee, appraisal fee, credit report, tax service, flood certification, VA funding fee, loan assumption and processing fees, etc.	Selling Expense	Not Deductible
Commissions	Selling Expense	Increase Basis
Government recording and transfer fees	Selling Expense	Increase Basis
Insurance—homeowner	Not Deductible	Not Deductible
Insurance—mortgage (PMI)	Selling Expense	Deductible
Interest	Deductible	Deductible
Loan origination fees (points)	Selling Expense	Deductible (even if paid by seller)
Real estate taxes—paid by seller in advance	Not Deductible	Deductible—SALT Limited
Real estate taxes—unpaid by seller	Deductible	Not Deductible
Title costs, including title insurance, abstracts, surveys, recording deed, etc.	Selling Expense	Increase Basis
Utility service installation	Selling Expense	Increase Basis

LOSS ON SALE OF A PERSONAL RESIDENCE

The taxpayer's principal residence is a personal asset. The loss on the sale of a principal residence is a personal loss and *is not* deductible. [IRC Sec. 165(c) and Reg. §1.165-9(a)]. This also includes a residence where a portion of the home was used for business. Conversely, any gain on the sale of a personal residence may be subject to tax unless an exclusion applies.

EXCLUSION OF GAIN FROM THE SALE OF A PRINCIPAL RESIDENCE (IRC SEC. 121)

IRC Sec. 121 provides that all or a portion of the gain on the sale of a personal residence may be excluded from gross income. Qualifying taxpayers can exclude up to $250,000 ($500,000 for MFJ filers and certain surviving spouses) in gain from the sale of a principal residence.

To qualify for the exclusion, a taxpayer must meet three tests:

1. *Ownership Test* – The taxpayer must have owned the residence for at least two of the five years before the sale or exchange.

2. *Use Test* – The residence must have been occupied by the taxpayer as a principal residence for at least two of the five years before the sale or exchange. Short temporary absences such as vacation or other seasonal absences are counted as periods of use, even if the residence is rented during the absence [Reg. §1.121-1(c)(2)(i)].

3. *One Sale in Two Years Test* – The exclusion is allowed each time a taxpayer meets the eligibility requirements, but the taxpayer must not have used the exclusion for any residence sold or exchanged during the two-year period ending on the date of the current sale or exchange [IRC Sec. 121(b)(3)].

For married taxpayers filing jointly, the maximum exclusion of $500,000 is available as long as:

1. Either spouse meets the ownership test,

2. Both spouses meet the use test, and

3. Neither spouse is ineligible because of the sale of another principal residence within the prior two years.

The $250,000 exclusion applies on a joint return when one or both spouses meet the ownership test, but only one spouse meets the use test or the one-sale-in-two-years test [IRC Sec. 121(d)(1)].

Two unmarried individuals who occupy the same principal residence can each use the $250,000 exclusion on the sale of their respective half [Reg. §1.121-2(a)(4), Example (1); and *Sung H. Hsu v. Comm.*, TC Summary Opinion 2010-68].

If a single taxpayer marries someone who has used the exclusion within two years, the taxpayer remains eligible for the $250,000 exclusion even though a joint return is filed [IRC Sec. 121 (b)(2)(B)].

EXAMPLE: Gain exclusion for taxpayer whose spouse has used the exclusion within two years

Homer and Marge are married on July 1, 2018, and move into Marge's home. Homer sells his home of the past 10 years for a $90,000 gain on December 30, 2019, and the entire gain is excluded under IRC Sec. 121. In May 2021, Marge sells her home for a gain of $450,000. Marge meets the ownership test (only one spouse must meet the test), Homer does not meet the use test or the one-sale-in-two-year test. Thus, Marge may exclude $250,000 because she alone meets all three tests.

PLANNING TIP: Had they asked, Homer and Marge would have been advised by their practitioner to wait until after December 31, 2021, to sell Marge's home to benefit from the entire $500,000 exclusion.

A taxpayer can elect not to have the gain exclusion apply [IRC Sec. 121(f)]. This election is made by simply reporting the sale on Form 8949, Sales and Other Dispositions of Capital Assets. There is no formal election.

PLANNING TIP: If a taxpayer experiences a large gain but is prevented from excluding it due to the two-year rule, they should consider amending their prior return and pay the tax on the smaller gain so that the current (larger) gain can be excluded.

In the case of a sale of a principal residence by a surviving spouse, the maximum gain exclusion is $500,000, the same as a qualifying couple. This maximum exclusion applies if the sale occurs within two years after the date of death of the spouse and the other use, ownership, and one-sale-in-two-years tests were met prior to the spouse's death [IRC Sec. 121(b)(4)]. This is in addition to any step-up in basis the surviving spouse may be entitled to under IRC Sec. 1014.

COURT CASE: In *Gates*, a married couple voluntarily demolished their principal residence and then reconstructed a new home on the same property. However, the couple never lived in the new home but sold the property shortly after the construction. The Tax Court held that the taxpayers could not exclude the gain on the new home because they did not meet the use test [*David A. Gates v. Comm.*, 135 T.C. 1 (2010)].

Legal-Interest Requirement

A trust is generally not allowed to claim the exclusion unless an individual is treated as the grantor of the trust under IRC Sec(s). 671 through 679.

Generally, an estate cannot claim the Section 121 exclusion. However, a bankruptcy estate can claim the exclusion if the party in bankruptcy is an individual who meets the ownership, use, and one-sale-in-two-year tests.

Exceptions to the Ownership Test

If a residence is transferred to a taxpayer incident to a divorce, the time during which the taxpayer's spouse or former spouse owned the residence can be counted as ownership [IRC Sec. 121(d)(3)(A)]. A taxpayer's period of ownership and use of a residence includes the period during which the taxpayer's deceased spouse owned and used the residence [IRC Sec. 121(d)(2)].

Exceptions to the Use Test

Out-of-Residence Care

A taxpayer who becomes physically or mentally incapable of self-care and who has owned and used a property as a principal residence for at least one year during a five-year period is treated as using the property as a residence during any time in which the taxpayer owns the property and resides in a state-licensed facility (including a nursing home) [IRC Sec. 121(d)(7)].

EXAMPLE: Use test out-of-residence care exception

On January 31, 2018, Fern purchased and moved into her new residence. On July 31, 2020, she moves into Almost Heaven Nursing Home. As long as she continues to own the residence while she is in the nursing home, she is treated as if she continues to live in her residence. For this rule to apply, Fern must have owned and used the residence as her principal residence for at least one year during the normal five-year testing period.

Note: Because the move to a nursing home is presumably for medical reasons, even if the residence is not owned and used for two years, a pro rata portion of the exclusion would apply. See the following discussion of reduced maximum exclusions.

Divorced or Separated Taxpayers

A taxpayer will be considered as using the property as a principal residence during any period of ownership while the taxpayer's spouse is granted use of the residence under a separation or divorce agreement [IRC Sec. 121(d)(3)(B)].

EXAMPLE: Use test divorce exception

In their divorce decree, Lucy has custody of her two children and the use of the family home until the youngest child reaches 18. Dez, her ex-husband, maintains joint ownership of the home. Even though the home is sold 10 years after his departure, Dez may exclude up to $250,000 of gain if he otherwise qualifies.

Active-Duty Personnel

Military, foreign service personnel, or members of the intelligence community serving on official extended duty can elect to suspend the five-year test period (for up to ten years) [IRC Sec. 121(d)(9)]. To meet the qualified extended duty, the taxpayer (or his spouse) must be serving extended duty at a duty station at least 50 miles from the residence or living in government quarters at the government's order [IRC Sec. 121(d)(9)(C)]. Extended duty is a period of active duty greater than 90 days (or an indefinite period of duty). The election is made by filing a return (original or amended) for the sale year and claiming the gain exclusion [Reg. §1.121-5(b)]. Similar rules apply to certain employees and volunteers of the Peace Corps [IRC Sec. 121(d)(12)].

EXAMPLE: Use test active-duty personnel exception

Captain Jack bought a home in January 2017. He lived in the home all of 2017 and 2018. In 2019, Jack was placed on extended duty until January 2023. Upon his return to the U.S., Jack sells his house and realizes a gain of $32,000. Because he is allowed to suspend the five-year period of the IRC Sec. 121 requirements, he may exclude the gain from the sale of his home [IRC Sec. 121(d)(9)].

REDUCED EXCLUSION FOR PERIODS OF LESS THAN TWO YEARS

The two-year ownership and use requirements and the one-sale-in-two-years provision could create a hardship for taxpayers in certain situations that are beyond their control. If a taxpayer does not meet the tests for exclusion, IRC Sec. 121(c)(2)(B) provides that a reduced amount of the $250,000 ($500,000 for MFJ filers) exclusion may apply if the sale or exchange is due to—

1. A change in place of employment;
2. A health-related reason; or
3. Unforeseen circumstances, which occurs if the primary reason for the sale or exchange is the occurrence of an event that could not have been reasonably anticipated before purchasing and occupying the residence [Reg. §1.121-3(e)(1)].

The primary cause for the sale or exchange must be one of the previous reasons. The following is a partial list of factors that may be relevant in determining the taxpayer's primary reason:

1. The sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time,
2. The suitability of the property as the taxpayer's principal residence materially changes (e.g., multiple births from one pregnancy makes the home too small),
3. The taxpayer's financial ability to maintain the property materially changes (e.g., taxpayer is unable to afford the home because of job loss or receiving unemployment benefits), or
4. The circumstances giving rise to the sale or exchange are not reasonably foreseeable when the taxpayer begins using the property.

The available exclusion is equal to $250,000 (or $500,000), multiplied by the percentage that is the smaller of:

1. The aggregate periods during which the ownership and use requirements were met during the five-year period ending on the date of sale or exchange divided by two years, or
2. The period after the date of the most recent sale or exchange to which the exclusion applied, divided by two years.

On joint returns, the amount of the exclusion is the sum of the amounts that each spouse is entitled to if he were not married. The result is that the exclusion on a joint return in which one spouse does not qualify for the full $250,000 exclusion may fall somewhere between $250,000 and $500,000.

EXAMPLE: Change in place of employment exclusion

Sandy sold her residence on September 1, 2020 and excluded $245,000 of gain. She bought a new house on the same date. On December 1, 2020, she moved out of the house to accept a promotion in a state 400 miles away. She sold the house on October 1, 2021, and realized a $25,000 gain. Although she did not own and occupy the house for two years and it has been less than two years since she used the exclusion, Sandy is allowed a partial exclusion since she moved because of a change in place of employment.

She owned and occupied the residence for 91 days, and at the time of sale it had been 395 days (i.e., 13 months) since she last used the exclusion. The shortest of these two periods is 91 days, so she is entitled to an exclusion of up to $31,164 [(91 ÷ 730) × $250,000 maximum allowable exclusion]. Any gain in excess of $31,164 would be taxed as a long-term capital gain.

CONVERTING OTHER-USE PROPERTY TO THE PRINCIPAL RESIDENCE

The 2008 Housing and Economic Recovery Act placed restrictions on the use of the Section 121 exclusion for gains relating to property held for purposes other than principal residence that is subsequently converted to principal residence status. More specifically, this provision impacts second homes, vacation homes, and rental properties that are converted to principal residence use after December 31, 2008.

This provision reduces the gain eligible for Section 121 exclusion. It *does not* reduce the maximum exclusion amount ($250,000 single, or $500,000 for qualifying MFJ filers). Accordingly, taxpayers who are forced to recognize income under this provision can still potentially get the full exclusion.

Nonqualified use is any use other than that of a principal residence after December 31, 2008. Use as a secondary home, a vacation home or a rental property prior to the principal residence use is nonqualified use. Any nonqualifying use prior to January 1, 2009, is not treated as nonqualifying use. Accordingly, if the conversion to principal residence status occurred on or before January 1, 2009, the property is grandfathered; no nonqualified use calculation is required for periods prior to 2009.

Nonqualified use excludes periods after its last use as a principal residence within five years of the sale. For these properties the normal two-out-of-five rules apply. Nonqualified use excludes temporary absences (not to exceed two years) due to a change in employment, health, or unforeseen circumstances [IRC Sec. 121(b)(5)(C)(ii)(III)].

NOTE: This change is important for taxpayers who hoped to convert rental or vacation home property into a principal residence and take full advantage of the Section 121 exclusion. Gain allocated to periods of nonqualified use after 2008 are not excluded.

The gain is allocated to the period of nonqualified use according to the following fraction:

$$\frac{\text{Aggregate period of nonqualified use (after 2008)}}{\text{Total period of ownership}}$$

Negative Effect of Depreciation

Any realized gain on the sale of a principal residence that is attributable to depreciation claimed after May 5, 1997, is also not eligible for the exclusion [IRC Sec. 121(d)(6) and Reg. §1.121-1(d)(1)].

The gain recognized that is associated with prior depreciation deductions is determined first before calculating the amount of recognized gain that is associated with periods of nonqualified use. This depreciation amount is treated as unrecaptured Section 1250 gain [IRC Sec. 121(b)(5)(D)].

EXAMPLE: Determining effect of depreciation on gain from principal residence sale

Rick, an individual, buys a property on January 1, Year 9 (a year beginning after December 31, 2008), for $400,000, and uses it as rental property for two years, claiming $20,000 of depreciation deductions. On January 1, Year 11, Rick converts the property to his principal residence. On January 1, Year 13, Rick moves out, and sells the property for $700,000 on January 1, Year 14.

Rick must recognize $20,000 of gain attributable to depreciation. Of the remaining $300,000 gain, 40% of the gain (two years divided by five years), or $120,000, is allocated to nonqualified use and is not eligible for the Section 121 exclusion. Since the remaining gain of $180,000 is less than the maximum amount of gain of $250,000 that can be excluded, the remaining gain of $180,000 is excluded from gross income under IRC Sec. 121.

OBSERVATION: Presumably, the period of time in the fraction is expressed in either days or months in the same manner as the fraction that applies for determining the amount of the reduced exclusion for certain taxpayers failing to meet the ownership and use requirements, or for taxpayers who have sold or exchanged principal residences within two years, However, the IRS uses days of nonqualified use to compute the amount of gain allocated to nonqualified use on its How to Figure Your Taxable Gain or Loss Worksheet in IRS Pub No. 523 (2019).

PLANNING TIP: The “period of nonqualified use” (as used in the numerator in the fraction) does not include any period before January 1, 2009. But, the denominator (i.e., the period that the taxpayer has owned the property), includes periods of ownership before January 1, 2009.

EXAMPLE: Determining effect of depreciation on gain from principal residence sale—Scenario 2

The facts are the same as in the previous example, except that Rick sells the residence for $900,000. Rick must recognize $20,000 of gain attributable to depreciation. Of the remaining $500,000 gain, 40% of the gain (2 years ÷ 5 years), or $200,000, is allocated to periods of nonqualified use and *is not* eligible for the Section 121 exclusion. Of the remaining $300,000 of gain, $250,000 can be excluded from his gross income under the maximum amount of the Section 121 exclusion.

CONVERSION OF A RESIDENCE TO A RENTAL OR BUSINESS USE

A taxpayer cannot convert a nondeductible personal loss into a deductible business loss merely by renting out the personal residence before the sale. If the residence is converted to business use, the basis for computing depreciation and determining the loss is the lesser of—

1. The FMV on the date of the conversion, or

2. The adjusted basis on the date of the conversion. [Reg. §1.165-9(b)(2)].

If the residence is converted to business use, the basis for determining a gain on disposition is the property's adjusted basis on the date of the conversion. The tax law is not concerned with gains on converted property because gains are recognized regardless of the nature of the property.

EXAMPLE: Effect of converting a personal residence to business use

Hyatt owns a personal residence with an adjusted basis of $280,000. He is unable to sell his home in 2020, so he converts it to rental property when the fair market value is $260,000. Hyatt's basis for loss and depreciation is $260,000. The $20,000 decline in value is a personal loss and will not be recognized for tax purposes. His basis for gain is $280,000.

During a two-year rental period, Hyatt claims $16,000 of depreciation. In 2022, he sells the property for $260,000. To compute his gain/loss he must make two calculations:

1. **Gain:** Hyatt will look at the adjusted basis of the property ($280,000), less depreciation, for a net tax basis of $264,000; he does not have a gain, as the gain computation results in a *loss* of $4,000.

2. **Loss:** Hyatt will then look to the FMV on the date of the conversion ($260,000), less depreciation, for a net tax basis of $244,000; since the adjusted basis is below the selling price, he does not have a loss.

For properties converted to rental or business use, taxpayers need to document the FMV on the date of change (an appraisal is the best documentation). Lack of documentation may cause the loss (and/or depreciation) to be reduced or disallowed [*Meurer v. Comm.*, 47 AFTR 417 (221 F.2d 223), (CA2)].

RECENT DEVELOPMENT: In PLR 201944006, the IRS held that married taxpayers could exclude gain on the disposition of their principal residence turned investment property after the residence was destroyed by fire and the land was subsequently sold.

HOME OFFICE DEDUCTION AND SALE OF RESIDENCE

If a taxpayer's property is used partly as a residence and partly for business, the treatment of any gain on the sale depends on whether the part of the property used for business is part of the home or a separate structure.

Part of Home Used for Business

If a room is used as a home office or rooms are used for daycare, gain on the sale of the property does not need to be allocated between the business part of the property and the part used as a home. In addition, the sale of the business portion does not need to be reported on Form 4797. However, depreciation allowed or allowable after May 6, 1997, must be recaptured. [Reg. §1.121-1(d)]

EXAMPLE: Treatment of business use of residence

Barbara has lived in her residence since 1988. During 2011, she began using 20% of her residence (two rooms and a storage area) as a qualified office-in-home and claimed $5,500 for depreciation. During 2020, she sells her residence for a $150,000 gain and moves to another state. She will be allowed to treat 100% of the residence as meeting the use test for a qualified residence. However, she must recapture the $5,500 of depreciation.

Note: If the only deduction ever claimed for the home office was the safe harbor simplified method (available after 2012), then no depreciation is deemed to have been claimed and the full residence qualifies for the exclusion.

Separate Structure Used for Business

If a separate structure from the residential portion is used for business, the taxpayer must treat the sale of the home as the sale of two properties and allocate the gain between them:

1. Gain (or loss) allocable to the business portion is taxable as a sale of a business asset.

2. The gain allocable to the residential portion may qualify for the Section 121 exclusion.

Allocation of the amount realized between the business portion and the residential portion must be the same as the method the taxpayer used to determine the depreciable portion.

Depreciation recapture only applies to depreciation claimed for which a tax benefit was derived. If a deduction limitation caused the depreciation to be suspended and carried forward, sale of the residence would not trigger taxability for what was carried forward but unused.

EXAMPLE: Treatment of gain on separate business use structures on personal residence property

Digs owns property consisting of a house, a stable, and 35 acres of land. He uses the stable and 28 acres for business purposes for more than three years during the five-year period preceding the sale. He uses the house and the remaining seven acres as a principal residence during the entire period of ownership. For periods after May 6, 1997, he claims depreciation deductions of $10,000 for business use.

Digs sells the entire property during the year at a gain. The stable and 28 acres used in the business are separate from the dwelling unit, so allocation rules apply. He will need to allocate the basis and sales price between the residence and business-use portions. In addition, $10,000 of the gain realized on the business portion is subject to Section 1250 recapture.

RESIDENCE ACQUIRED VIA SECTION 1031 EXCHANGE

A longer holding period is required for residences acquired in a like-kind exchange. The Section 121 exclusion on the sale or exchange of a principal residence does not apply if the residence was acquired within the prior five years in an IRC Sec. 1031 like-kind exchange. The five-year holding period begins on the date of the exchange.

The provision was enacted to prevent abuse of IRC Sec. 121 by converting trade or investment property into a personal residence to use the exclusion after two years. However, the strategy still works if the replacement property is held at least five years after the exchange.

The rules for nonqualified use still apply beginning in 2009.

EXAMPLE: Treatment of residence acquired via Section 1031 exchange

Maison owned a fully depreciated apartment building in Cleveland, OH. After hearing the projected tax due if he would sell, he exchanges the property for a rental home in Fort Lauderdale, FL, in December 2018. He rents the home to snowbirds for the next two years.

In 2021, Maison retires and moves to Florida, converting the property to a principal residence on January 1, 2021. Two years later (January 2, 2023) he sells the home and attempts to exclude the gain after depreciation recapture. The five-year holding period has not been met and the gain will be fully taxable. He needed to own the property for at least one more year to meet the five-year holding period.

The five-year period is firm. There is no pro rata exception for any reason.

REVERSE MORTGAGES AND HOME EQUITY CONVERSION MORTGAGES

The *reverse mortgage* is a financing method created to access tax free funds from the equity in a primary residence. The *home equity conversion mortgage* (HECM) is a reverse mortgage program designed by the U.S. Department of Housing and Urban Development (HUD) but insured by the Federal Housing Administration (FHA). Ninety percent of all reverse mortgages are HECMs.

How HECMs Differ from Traditional Mortgages

Financial institutions which offer traditional home equity loans/mortgages qualify borrowers based upon income and credit scores. However, income and credit scores *are not* considerations for an HECM.

HECM borrowers must be at least 62 years of age and go through a counseling program to understand reverse mortgages. While home equity loans require monthly payments from the borrower to the lender, an HECM borrower makes no payments at all; the lender makes payments to the borrower either in the form of an upfront lump sum or through a monthly or other form of periodic payment.

Home equity loans generally have a limited term, such as 5 or 10 years. However, an HECM continues until the borrower—

1. ceases to use the property as a primary residence (through death or otherwise),
2. fails to pay property taxes and insurance bills,
3. lives away from the home for more than 12 consecutive months, or
4. allows the property to fall into disrepair.

Ways to Receive the Proceeds

HECMs offer several ways to receive loan proceeds:

1. *Lump Sum* – The borrower receives a single sum at closing and funds can be used for any purpose.
2. *Monthly* – The borrower receives a fixed monthly payment for as long as the property remains the borrower's primary residence.
    a. Even if the home's value changes or the rate of interest fluctuates, no factor will interrupt the fixed monthly payment that has been agreed upon.
    b. In the event the funding institution fails, the FHA agrees to continue to pay the borrower.
3. *Line of Credit* – The borrower uses the HECM just like a credit line, drawing funds at different times and at different amounts, at the borrower's discretion. The homeowner is not required to borrow funds.
4. *Term Loan* – The borrower has a structured monthly payment limited to a predetermined number of years.
5. *Combination* – The borrower can combine the line of credit plus monthly payments over a predetermined number of years.

Advantages

Several advantages to taking out a reverse mortgage include—

1. The borrower still owns their residence.

> **PLANNING TIP:** Taxpayers with significant gain on the sale of a principal residence can get to the equity without paying any tax by way of a reverse mortgage.

2. The borrower can access the equity in the home tax-free.
    a. The maximum proceeds are the lesser of the appraised value or $765,600 (for 2020) or sales price. The net proceeds are typically 56%–75% based on age.
3. The proceeds can be used any way the borrower wants (e.g., increase household income, decrease debt, buy a new home, or pay medical bills).
4. Regardless of property value upon disposition, the loan repayment amount due from the borrower cannot exceed sale proceeds due to FHA insurance protection.

> **EXAMPLE: Using reverse mortgage proceeds to purchase a new residence**
>
> Julia is a new grandmother. She wants to be near the grandkids that are in Florida. On a recent trip she found a desirable home that was available for a greatly reduced price. Because of her limited income, she would not qualify for a conventional mortgage. She decides, however, to take out a reverse mortgage on her present home and use the proceeds to purchase the new Florida residence. Afterward she places her old residence up for sale.

EXAMPLE: Using a reverse mortgage to pay real estate taxes

Kathy's home is comprised of a small home with 15 acres of land which is now prime commercial real estate. Kathy is well into her 80s. The home and land have been valued at $7.5 million and her basis is $450,000. Kathy wants to transfer the home on her death to her children and grandchildren and get the step-up in value. She takes out a reverse home equity loan solely to pay the real estate taxes that have risen drastically over the last several years.

Other Considerations

Reverse mortgage borrowers should be aware of the following:

1. The monthly mortgage principal and interest obligation continues to increase, albeit silently, while the proceeds are being used. Interest is not deductible.
2. The HECM creates no taxable income, nor does it offer any tax deduction. A borrower dependent upon Medicaid should be aware mortgage proceeds are an asset and may affect Medicaid eligibility.
3. Fees are the least discussed but the scariest part of these transactions:
    a. Upfront fees include—
        i. mortgage insurance premium (2% based on lesser of appraised value or $765,600),
        ii. origination fees (the greater of $2,500 or 2% on first $200,000 of the home's value, plus 1% on remaining over $200,000, total origination fees not to exceed $6,000),
        iii. closing costs and out-of-pocket costs for the appraisal (average cost is $450).
    b. Ongoing fees include mortgage insurance premium (.5% of outstanding loan balance), servicing fees and compounded interest.

PLANNING TIP: Practitioners should discuss the fees with their client. High upfront fees make it very costly if the client has to move out. If the client's goal was to leave money to heirs, they will find it dries up quickly.

WHERE TO GO FOR MORE INFORMATION

- IRS Publication 523, *Selling Your Home*
- IRS Publication 530, *Tax Information for Homeowners*
- AARP's general reverse mortgage information at **www.aarp.org/revmort**
- National Reverse Mortgage Lenders Association: **www.reversemortgage.org**
- HUD Home Equity Conversion Mortgage (HECM) information available at **www.hud.gov/program_offices/housing/sfh/hecm**

CHAPTER 15: SOCIAL SECURITY AND MEDICARE

Learning Objectives

Completion of this chapter will enable participants to—

- Explain the complications and taxation of social security benefits.
- Identify how Medicare is affected both by when the benefit is chosen and income of the beneficiary.

WHAT'S NEW

1. The future of social security
2. Maximizing social security benefits
3. IRMAA tables
4. Discussion on Medicare

FUTURE OF SOCIAL SECURITY BENEFITS

According to a recent forecast (2020) from the Congressional Budget Office, it is estimated that the OASI "trust fund" will be depleted in 2030, with incoming funds only able to cover ¾ of the benefits payable.

The solutions for social security funding comprise—

1. Changing tax policies to increase the annual revenue of the SSA,
2. Changing the benefit formula to reduce costs, or
3. A combination of 1 and 2 to share the burden of the funding shortfall.

The tax on social security benefits is a funding method devised back in 1981 to assist with the shortfall of social security funding. Congress indicated when this modification was made that "only the richest of Americans" would be subject to this taxation. The related income tax collected as of the 1983 legislation is added to the social security trust fund. It should be noted that these $25,000/$32,000 thresholds were never indexed. The additional tax as the result of the 1993 legislation (increase from 50 to 85%) is deposited in Medicare's Hospital Insurance trust fund.

SOCIAL SECURITY BENEFITS

To become eligible for retirement benefits, workers must meet minimum age and minimum work requirements. To collect a benefit, a worker must attain a minimum age of 62. The earliest month of eligibility is the first full month of being age 62 (unless a widow or widower).

1. To pass the minimum work requirement, a worker must have accumulated 40 credit quarters.
2. For 2021, a quarter of credit is earned for each $1,470 of FICA income, to a maximum of four credits for the year (or minimum earnings of $5,880).

Retirement, disability, and survivor benefits are based on the Primary Insurance Amount (PIA), which represents the monthly amount an individual can receive at full retirement age (FRA), also called normal retirement age (NRA).

The PIA is calculated using a worker's "adjusted indexed monthly earnings" or AIME. The percentage of replaced wages provided as a benefit is skewed higher for the first (lower) wages earned. The benefit does increase as the AIME increases but not at the same percentage.

These percentage changes are called bend points. The PIA is the sum of three separate percentages of portions of AIME. These portions depend on the year the worker reaches age 62. If reaching 62 in 2021, the PIA is the sum of—

1. 90% of the first $996 of AIME, plus
2. 32% of AIME over $996 and through $6,002, plus
3. 15% of AIME over $6,002.

The Social Security Administration has an online tool for viewing a worker's annual statement. To access the statement and other social security benefits information online, individuals must register at www.ssa.gov/myaccount. (**Note:** Certain restrictions regarding security validation apply.)

The following table shows benefits as a percentage at varying birth years and retirement ages:

Full Retirement and Earlier Age Benefits by Year of Birth						
		Benefit as a Percentage of PIA (Primary Insurance Amount) Starting at Age:				
Year of Birth	**Full (Normal) Retirement Age**	**62**	**65**	**66**	**67**	**70**
1943–1954	**66**	**75.00**	**93.37**	**100.00**	**108.00**	**132.00**
1955	66: and 2 months	74.16	92.22	98.89	106.67	130.67
1956	and 4 months	73.34	91.11	97.78	105.33	129.33
1957	and 6 months	72.50	90.00	96.67	104.00	128.00
1958	and 8 months	71.67	88.89	95.56	102.67	126.67
1959	and 10 months	70.83	87.78	94.44	101.33	125.33
1960 or after	67	70.00	86.67	93.33	100.00	124.00

Should a Worker Retire Early (Age 62) or Late (Age 70)?

Most retirees will receive more total dollars by starting benefits later. Financial planners should assist in a review of a client's health, family history, and cash-flow needs prior to making a timing recommendation.

FFECT OF EARNED INCOME ON SOCIAL SECURITY BENEFITS

An "earnings test" will determine social security payment amounts. Earnings limits are in effect for age 62 to full retirement age.

Retirement Earnings	2020
Year individual reaches full retirement age (FRA) and only for those months for which an individual is not actually at full retirement age for a full month.	$50,520 per year $4,210 per month
For any year in which an individual does not attain full retirement but is at least age 62.	$18,960 per year $1,580 per month

In addition to the earnings test, the individual cannot have performed substantial services in self-employment during the first year of retirement. "Substantial services in self-employment" means devoting more than 45 hours a month to a business or between 15 and 45 hours to a business in a highly skilled occupation.

EXAMPLE: Effect of SE-income on Social Security payments

Jeff retires at age 62 on June 30, 2021. He earned $37,000 before he retired. On October 5, Jeff starts his own business. He works at least 15 hours a week for the rest of the year and earns an additional $3,000 after expenses. His total earnings for 2021 are $40,000.

Although his earnings for the year substantially exceed the 2021 annual limit ($18,960), Jeff will receive a Social Security payment for July, August, and September. This is because he was not self-employed and his earnings in those three months are $1,580 or less per month, the limit for people younger than full retirement age.

Jeff will not receive benefits for October, November, or December of 2021, because he worked in his business over 45 hours per month for all three months. Beginning in 2022, the deductions are based solely on Jeff's annual earnings limit.

Social security checks do not automatically stop if a "retiree" exceeds earnings limits; instead, checks are reduced by a formula applied to the excess earnings:

1. From age 62 and prior to the calendar year a retiree reaches full retirement age, the reduction formula is 50% of the excess earnings, which is a loss of $1 in benefits for every $2 in earnings exceeding $18,960.

2. During the calendar year, a retiree reaches full retirement age, the reduction formula is 33.3% of the excess earnings, which means a loss of $1 in benefits for every $3 in earnings exceeding $4,210 per month times the number of months prior to the first full month the retiree reaches full retirement age.

3. If an individual loses benefits due to earnings, at full retirement age the benefit is adjusted (higher) to reflect the actual amounts collected. the This is called the "Adjustment to the Reduction Factor" and is automatic.

A person entitled to their own social security benefits and benefits under the family member accounts receives the higher amount, but not both.

Each family member can benefit up to 50% of an insured's PIA, however benefits for the entire family is limited between 150% and 188% of the worker's basic Social Security or PIA.

Claims should be filed three months prior to the planned effective date.

RESTRICTED APPLICATION PROGRAM

Many advisors recommend individuals delay collecting their benefit for as long as possible to receive the highest benefit during their lifetime.

The restricted application was eliminated for applicants born after January 2, 1954, due to a provision of the Bi-Partisan Budget Act. It is still available for those who were born prior to this date even if they have not currently reached FRA. In order to make a restricted application the taxpayer:

1. Must be born before January 2,1954, and
2. Must have reached their full-retirement age.

By restricting the application strictly to spousal or ex-spousal benefit, the applicant can receive a social security payment and still earn the delayed earnings credit on their own account.

EXAMPLE: Restricted application effects.

Rick retired 2 years ago at 66 and is collecting $2,000 per month. His wife Diane continued to work until she turned 66 this year. Both are fully insured. Typically, Diane would file a normal unrestricted application and if her own PIA is greater than 50% of Rick's PIA, she would receive benefits based on her own work record. Diane's PIA is $2,000.

Diane files a restricted application, which limits her application to spousal benefits only, and receives $1,000 a month. Initially, this may seem counter-productive, but by restricting her application to a spousal benefit, she is delaying her application on her own work record, so she will earn delayed retirement credits. At 70, Diane applies for an unrestricted benefit and receives 32% more. Her benefit is $2,640 ($2,000 × 132%, not including COLA).

For the four years (age 66–70) she "gave up" $1,000 a month or $48,000. It will take 75 months or 6.25 years, or age 72.25 [$48,000 ÷ ($2,640 – 2,000)] to break-even (ignoring the time value of money).

Note: An additional advantage of this planning technique is if Diane were to pre-decease Rick, he would then receive her increased benefit amount as a surviving spousal benefit.

To file a restricted application, a spouse must be receiving benefits, or the applicant qualifies to collect off an ex-spouse's record.

There is no additional benefit amount for delayed benefits for spousal benefits.

MAXIMIZING SOCIAL SECURITY BENEFITS

Frequently, clients will ask when they should start taking their social security benefits. This common question has no guaranteed correct answer. Further, the follow-up question will likely be, "What can I do to maximize my social security benefits"?

An often-heard argument about social security is, "If I had taken the money that was placed in the social security system and purchased X retirement asset, I would have Y-amount more." While this may be true, social security is more than a simple retirement account. There are family benefits, spousal benefits, and disability benefits included as well.

The answer to each question is dependent on many factors that are impossible to answer until the end of a person's life. Like all defined benefit plans, the amount paid to the beneficiary will depend on the number of credits and the longevity of the beneficiary.

There are five strategies to maximize social security benefits:

1. *Analyze your life expectancy.* Review an expected life expectancy with your health care professionals. Understanding how long you might live is an important factor in assisting in the decision of when to take benefits.

2. *Understand the range of benefits available.* Determine how much each age decision will yield, this is called an *income gap analysis*. There are arguments on both sides, take the benefit now and save your retirement accounts. Defer the decision and take the shortfall from your retirement account because can you earn 8% guaranteed from your retirement account. Use the tool available at **www.aarp.org/work/social-security/social-security-benefits-calculator** to quantify that decision.

	Start at 62	Start at Full Retirement Age	Start at 70
Monthly Benefit	$750	$1,000	$1,320
Yearly Benefit	$9,000	$12,000	$15,840
Aggregate Benefits Paid Through Age 85	$216,000	$240,000	$253,440

3. *Maximize your current earnings.* The greater your earnings the greater the benefit. If you can replace lower earnings with higher earnings, you can increase the benefit. SSA bases the payment on your 35 highest earning years after indexing. Run the numbers, replacing a few lower years can yield a larger social security payment. Please note that earnings starting with the year the recipient reaches age 60 are not indexed.

4. *Coordinate spousal benefits.* Those individuals who were born prior to 01/02/1954 have more choices than those born after 01/01/1954 by using the restricted benefit. Consideration of age differences can matter. A surviving spouse will be eligible for a total benefit equal to at least the benefit of the deceased spouse.

5. *Integrate social security into your retirement income plan.* Determining the withdrawal necessary from retirement plans in conjunction with social security benefits can facilitate an effective retirement plan.

BASIC MEDICARE PARTS A, B, AND D FACTS

As of December of 2018, there were 10,000 Medicare subscribers entering the system each day, with 60 million (15% of all Americans) enrolled in the Medicare program. About 10% (4.4 million) rely solely on Medicare. However, about 50% of that 4.4 million earn less than 200% of the Federal Poverty Limit (FPL).

The Medicare system no longer relies on social security numbers for Medicare beneficiary identification. Starting in March 2016, Medicare enrollees were furnished new Medicare cards with a unique Medicare identification number.

There are three parts to the Medicare system: Part A, hospital coverage; Part B, doctor coverage; and Part D, drug coverage.

According to the Kaiser Foundation in 2018, benefit payments, which are managed by the SSA, totaled about $636 billion annually for Part A and Part B, and are split almost evenly:

1. Part A is earned during working years; those with 40 quarters of credit or more will earn lifetime coverage with no premium for coverage. Those with fewer than 40 credits will pay a monthly premium.

2. Part B is elective: all eligible participants will pay a minimum monthly premium ($148.50). Those with income in excess of thresholds will pay an additional premium which is labeled the income related monthly adjustment amount (IRMAA). If an individual becomes eligible for Medicare Part B and fails to enroll, there is an additional premium that will apply for the individual's lifetime.

Medicare Part D is a voluntary outpatient prescription drug benefit for people with Medicare, provided through private plans approved by the federal government. Beneficiaries can choose to enroll in either a standalone prescription drug plan (PDP) to supplement traditional Medicare or a Medicare Advantage prescription drug plan (MA-PD):

1. There are currently 996 Medicare Part D standalone drug plans.

2. Beneficiaries with low incomes and modest assets are eligible for assistance with Part D plan premiums and cost-sharing.

3. Medicare Part D enrollment has grown each year since its inception in 2016. Currently, enrollment consists of over 46 million participants.

4. Like Part B, there is a base premium plus additional charges for those who exceed the MAGI threshold.

Like social security, Medicare faces several financial pressures. As the population ages, there are fewer people in the workforce while the number of retirees increases, leading to more people receiving benefits from the system than people paying into it.

Medicare Part A, Hospital Insurance, (the "trust fund" of Part A) is the focus of financial shortfalls. According to the 2020 Medicare Trustees report, the actuaries projected that assets in the Part A trust fund will be depleted in 2026. Income from payroll taxes and other revenues will only be able to support 90% of the program's costs. Over a long-term timeframe, Medicare Trustees estimate that it would take an increase of 0.76% of taxable payroll or a 16% reduction in benefits each year to bring the Health Insurance trust fund into balance.

Medicare Part B, Physician and Outpatient Costs, programs are covered by premiums (25%) and general fund revenues (75%). The funding for Part B statutorily covers the costs of the program and costs to the general treasury are decreasing slightly as Part B also receives funding by means-testing (IRMAA).

Medicare Part D, Drug Costs, cost funding (like Medicare Part B) is provided for by premiums (25%) and general fund revenues (75%).

There is little doubt that the demographics of the U.S. population will put increasing pressure on the costs of the U.S. health care system.

INCOME RELATED MONTHLY ADJUSTMENT AMOUNTS (IRMAA)

In 2021, Medicare beneficiaries whose income is in excess of $88,000/$176,000 will be required to pay an additional Medicare Part B and Part D premium known as IRMAA.

In 2021, of the 62.8 million Medicare beneficiaries, about 5 million "high income" beneficiaries will pay the IRMAA surcharge.

As a result of the 2018 Budget Reconciliation Act, there has been an increase to the brackets subject to the IRMAA surcharge. The following tables demonstrates exactly how these changes to IRMAA have impacted beneficiaries, especially higher MAGI beneficiaries.

These surcharges are often a surprise to taxpayers who have sold a property or had a significant change to their income. Often these changes are transitory but for many taxpayers, they are an annual cost. The IRMAA surcharge is based on the MAGI of the beneficiary two years prior. An individual who lives with their spouse but files a separate return will accelerate their IRMAA surcharge bypassing Levels 2–4.

Filing Individual Tax Return	File MFJ Tax Return	File MFS Tax Return	Medicare Part B Monthly Payment	Medicare Part D Adjustments
$88,000 or less	$176,000 or less	$88,000 or less	$148.50	Plan Premium
$88,001–$111,000	$176,001–$220,000	Not Applicable	$207.90	$12.30 + Plan Premium
$111,001–$138,000	$220,001–$276,000	Not Applicable	$297.00	$31.80 + Plan Premium
$138,001–$165,000	$276,001–$330,000	Not Applicable	$386.10	$51.20 + Plan Premium
$165,001–$500,000	$330,001–$750,000	$88,001–$412,000	$475.20	$70.70 + Plan Premium
$500,001 and up	$750,001 and up	$412,001 and up	$504.90	$77.10 + Plan Premium

APPEALING AN IRMAA SURCHARGE

It is possible to appeal an IRMAA surcharge when a “life-changing” event occurs, something that will cause the beneficiary’s income to decrease. These include the death of a spouse, marriage, divorce, annulment, retirement or reduced work hours. A loss of an asset such as a rental property destroyed by a disaster or a pension that goes bankrupt.

A one-time boost to income is not an appealable event. The guide *How to Appeal a Higher Part B or Part D Premium* is available at **https://go.medicareinteractive.org/how-to-appeal-higher-part-b-or-d-premiums**.

WHERE TO GO FOR MORE INFORMATION

- **www.ssa.gov** (for annual benefit statement and other calculators)
- IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*

CHAPTER 16: RETIREMENT SAVINGS AND DISTRIBUTIONS

Learning Objectives

Completion of this chapter will enable participants to—

- Determine allowable IRA contributions, both traditional and Roth.
- Select appropriate defined contribution plans for clients.
- Calculate allowable contributions for owners and employees.

WHAT'S NEW THIS YEAR

1. The SECURE Act has changed numerous provisions of affecting retirement accounts and distributions.
2. The CARES Act eases the ability of beneficiaries to take withdrawals or distributions.
3. Updated limitations for plan participants and IRA account holders.
4. TCJA-extended period to rollover plan offsets.

TRADITIONAL IRAs AND ROTH IRAs

IRAs and retirement plans are protected in bankruptcy. ERISA qualified plans enjoy unlimited protection from creditor action in bankruptcy, this includes any amounts rolled into an IRA [see *Clark v. Rameker*, 134 S. Ct. 2242 (2014)]. IRA bankruptcy protection is limited to $1 million, indexed currently to $1,362,800. The next inflation adjustment will occur on April 1, 2022. There is no bankruptcy exemption for inherited IRA accounts.

> **NOTE:** Bankruptcy protection is not the same as creditor protection because bankruptcy protection covers only those who are in bankruptcy. ERISA plans are protected from creditors under the "anti-alienation" provision which prevents creditor attachment to qualified plan assets. The anti-alienation provisions do not extend to IRAs and retirement plans where the sole participants are the taxpayer and spouse.

Spousal IRA

For married couples, IRA contributions can be made for both spouses if their combined compensation is at least equal to the contributed amount and they file a joint return.

1. An IRA contribution is considered timely if—
2. Delivered to the trustee by the due date of the return without extension; the Section 7502 mailbox rules apply.

3. Armed forces personnel in combat zones, hazardous duty areas, and contingency operations (including spouses and dependents) have 180 days from—

    a. The last day they were in a combat zone, have qualifying service outside of the combat zone, or serve in a contingency operation (or the last day the area qualifies as a combat zone or the operation qualifies as a contingency operation), or

    b. The last day of any continuous qualified hospitalization for injury from service in the combat zone or contingency operation or while performing qualifying service outside of the combat zone.

4. In addition to the 180 days, the deadline is extended by the number of days that were left to take the action with the IRS when they entered a combat zone (or began performing qualifying service outside the combat zone) or began serving in a contingency operation.

EXAMPLE: IRA contributions from armed forces personnel in combat zones

Private Hans entered a combat zone on December 15, 2021. He had 122 days until the IRA contribution deadline of April 15, 2022. Hans left the combat zone on September 15, 2022. He now has 122 days plus 180 days (302 days), or until July 14, 2023 to make his 2021 IRA contribution.

Spouses may use a deceased spouse's earnings to qualify for their own account, [IRC Sec. 219(d)(4)]. Self-employment losses only offset other self-employment income, but not wages (Rev. Rul. 79-286). Amounts (other than combat pay) excluded from income such as foreign earned income and housing costs are not considered qualified income for IRA purposes.

Compensation Chart for IRA Purposes	
Includes	**Does Not Include**
Wages and salaries (W-2, Box 1 less any amount in Box 11 for nonqualified plans)	Earnings and profits from a property such as rental income
Net self-employment income. Self-employed losses only offset other self-employment income, not wages [Rev. Rul. 79-286]	Any amounts (other than combat pay) excluded from income such as foreign earned income and housing costs
Taxable alimony and separate maintenance payments	Interest and dividend income
Nontaxable combat pay (Form W-2, Box 12, Code Q) and military differential pay	Pension or annuity income
Partners' distributive share of earned income if the partner is active in providing services (PLR 7933069)	Income from a partnership for which no services were provided

Compensation Chart for IRA Purposes	
Includes	**Does Not Include**
Minister's earned income that is exempt from self-employment tax because the minister opted out of social security	Deferred compensation or social security benefits
Taxable scholarship and fellowship payments	S corporation distributions other than salary
Amount included in an individual's gross income and paid to the individual to aid the individual in the pursuit of graduate or postdoctoral study (SECURE Act)	
Payments received as qualified foster care payments and excluded from income as difficulty of care payments (SECURE Act)	

The TCJA made alimony no longer taxable for agreements executed after December 31, 2018. For IRA purposes, compensation includes any taxable alimony and separate maintenance payments received under a decree of divorce or separate maintenance but only with respect to divorce or separation instruments executed on or before December 31, 2018, that have not been modified to exclude such amounts.

Expenses for an IRA paid by non-IRA funds are considered to be plan contributions. There is an exception for wrap fees; however, the TCJA suspended the ability to deduct these fees as 2-percent miscellaneous itemized deductions for years 2018 to 2025.

A taxpayer may make contributions to an IRA during a year and later determine they wish to change the designation. A taxpayer may complete a change in designation up to the extended due date of the tax return [IRC Sec 408(d)(4)(A)]:

1. Treat all or part of the contribution as nondeductible (regular IRA), or

2. Withdraw any portion of the contribution (regular IRA or Roth IRA), or

3. Change the type of IRA (e.g., regular to Roth, Roth to regular).

TRADITIONAL IRA PROVISIONS (IRC SEC. 408)

Under the SECURE Act, any person with qualifying income may make a contribution to a regular IRA without regard to their age. When a taxpayer or spouse is covered by a retirement plan, deductible amounts are limited based on MAGI.

MAGI Phase-out Limits for Traditional IRA Deductible Contributions for Plan Participants			
Deductible IRA Phase-out	**2020**	**2021**	**2022**
Joint filer—plan participant	$104,000–$124,000	$105,000–$125,000	TBD
Joint filer—not a plan participant married to a plan participant	$196,000–$206,000	$198,000–$208,000	TBD
Single/HOH plan participant	$65,000–$75,000	$66,000–$76,000	TBD
MFS—lived with a spouse during the year	$0–$10,000	$0–$10,000	$0–$10,000

If otherwise eligible, a taxpayer can choose to designate a contribution as nondeductible [IRC Sec. 408(o)(2)(B)(ii)].

Form 8606, Nondeductible IRAs, is used to designate the amount of a nondeductible IRA contribution and is required for any year a contribution is made plus:

Any year an IRA is distributed, and a nondeductible contribution had been made in prior years, and

To maintain the record of basis of the regular IRA.

PLANNING TIP: Practitioners should prepare Form 8606 every year once a taxpayer makes a nondeductible contribution to assist in tracking the taxpayer's basis in the IRA.

A taxpayer may change the treatment of the contribution as deductible versus non-deductible by filing Form 1040X with Form 8606 for any open year.

Nondeductible and deductible IRA contributions may be made to the same account.

Penalties for certain Form 8606 failures:

1. $100 for overstatement of nondeductible contributions and taxpayer cannot show reasonable cause.

2. $50 failure-to-file if a required Form 8606 is omitted and taxpayer cannot show reasonable cause for the failure [IRC Sec. 6693(b)(2)].

ROTH IRA PROVISIONS (IRC SEC. 408A)

Contributions to Roth IRA accounts are nondeductible, but all qualified distributions, including earnings, are nontaxable. There are three ways to fund a Roth IRA:

1. *Regular contributions.* Eligible contributions from those who meet income eligibility requirements can make contributions to a Roth IRA.

MAGI Phase-Out Limits for Roth IRA Contributions			
	2020	**2021**	**2021**
Married Joint	$196,000–$206,000	$198,000–$208,000	TBD
Single/HOH	$124,000–$139,000	$125,000–$140,000	TBD
Married Separate	$0–$10,000	$0–$10,000	$0–$10,000

2. *Backdoor Roth IRA Contributions.* A contribution made to a nondeductible traditional IRA contribution and converted to a Roth IRA. If done properly there can be little, or no tax consequence associated with the conversion.

TIP: Some practitioners have questioned whether the backdoor Roth IRA is allowed, as IRS has never issued any form of guidance. In a statement, during a question regarding the strategy, Donald Kieffer, Jr. an attorney for the IRS Tax-Exempt and Government Entities Division said, "But in this one that we're talking about, it's allowed under the law."

CAUTION: All amounts (basis and no basis accounts) in any Section 408 plans must be aggregated to determine the impact on the taxable amount of this conversion. Section 408 plans include employer plans, SEPPs and SIMPLEs. Employees with employers who sponsor these types of plans will find it difficult for the Back Door ROTH IRA strategy.

OBSERVATION: The elimination of the age restriction for a regular IRA will allow a taxpayer to use the backdoor Roth IRA strategy as long as they have earned income. (See earlier table.)

3. *Rollover contributions.* Amounts from other qualified plans such as regular IRAs and employer plans can be converted to a Roth IRA by transferring the funds and paying tax on the amount converted. There is no MAGI limitation for converting funds to a Roth IRA.

MILITARY BENEFICIARIES

Recipients of a military death gratuity (MDG) or a Service Members Group Life Insurance (SGLI) program are eligible to roll over all or part of the amount to a Roth IRA [IRS Pub. 590-A].

1. Eligible amounts must be reduced by any amounts contributed to a Coverdell ESA.
2. The rollover must be completed before the end of the one-year period beginning on the date the taxpayer received the final payment.
3. The amount contributed is treated as part of the cost basis (investment in the contract) in the Roth IRA and is not taxable when distributed.
4. As a rollover, it is not subject to any MAGI limits.

SELF-DIRECTED IRAS

Most investments are allowed in an IRA, but not investments in collectibles, including artwork, metals, gems, stamps, and coins [IRC Sec(s). 408(m)(1) and (2)], investments in life insurance contracts [IRC Sec. 408(a)(3)].

All IRA investments must be held by a trustee or custodian. Any applicable purchase agreements, title insurance, and insurance policies must be titled in the name of the IRA.

COURT CASES: A taxpayer failed to obtain acceptance of property by the IRA's trustee (Charles Schwab). The court ultimately ruled the IRA trustee could not and would not accept the property; therefore, the property was not held by the IRA. The court treated the property purchase as a distribution, and the gain on the sale of the property was a personal taxable transaction and not in the IRA. To make matters worse, putting the proceeds of the sale in the IRA was an excess contribution subject to a 6% excise tax (*Dabney v. Comm.*, TC Memo 2014-108).

A taxpayer obtained the opposite result for his self-directed IRA transaction. The custodian/brokerage firm (Merrill Lynch) refused to purchase shares of stock directly. Their wire transfer to the corporation per the taxpayer's instructions did not result in a taxable distribution, because the funds the IRA released went straight to the investment, the shares were issued to the IRA, and no cash, check, or wire transfer passed through the taxpayer's hands. The IRS's arguments regarding his status and role in the transaction or that he held the stock certificate did not impress the Tax Court given the previous facts, plus the fact he could not have realized any practical utility or benefit as the certificate was titled in the IRA's name (*McGaugh v. Comm.*, TC Memo 2016-28).

Prohibited transactions are defined in IRC Sec. 4975(c), but are only applicable to a disqualified person, which is defined in IRC Sec. 4975(e)(2). The result of entering into a prohibited transaction is a disqualification of the entire account.

Disqualified persons for an IRA include:

1. The IRA owner and spouse, ancestors, and descendants of the IRA owner and spouse,
2. Any entity owned by 50% or more by any of the previously mentioned individuals, and
3. A fiduciary.

A *prohibited transaction* means any direct or indirect [IRC Sec. 4975(c)(1)]:

1. Sale, exchange, or leasing of property between an IRA and a disqualified person,
2. Lending of money or extension of credit (guarantee of debt) between an IRA and a disqualified person,
3. Furnishing of goods, services or facilities between an IRA and a disqualified person,
4. Transfer to, or use by, or for the benefit of, a disqualified person of the income or assets of the IRA,

5. Dealing with the income or assets of a plan by a fiduciary in the interest of or for the account of the fiduciary, or

6. Fiduciary acting as an individual or in any other capacity in any transaction involving the plan on behalf of a party with adverse interests to those of the plan or the interests of its participants or beneficiaries.

Prohibited transactions are prohibited regardless of whether it was beneficial or not. The burden of proof is on the taxpayer to prove no direct or indirect benefit.

PRACTICE TIP: Be aware of situations that have the appearance of being an indirect benefit. For example, a lease to a non-disqualified friend or relative may well be a prohibited transaction.

An IRA can borrow money using nonrecourse financing only. An IRA's owner cannot guarantee the loan.

COURT CASE: The Tax Court has held that a taxpayer's personal guarantees of loans made to a corporation formed by him and owned by his IRA were prohibited and resulted in a deemed distribution of all of the IRA assets as of the first day of the tax year and the 10% IRC Sec. 72(t) excise tax was imposed [*Thiessen*, (2016) 146 TC No. 7].

All payments for expenses for property owned by an IRA must be paid from IRA funds. If a property is mortgaged, the loan payments must also come from IRA funds.

Real estate in an IRA has become increasingly popular and should be viewed with caution; the trustee (custodians will not work in this application, as the investment must be actively managed by a trustee and not the beneficial owner of the IRA) should be carefully selected:

PRACTICE TIP: *Be careful!* Work only with trustees who have experience and are qualified to work with real estate in IRAs. There are numerous promoters crossing the country promoting the use of real estate in an IRA. Many are not good at what they claim to do, and some are not even legitimate.

1. Property must be business-use and not personal-use property.

2. The IRA must pay all expenses. Any expenses paid by the IRA owner will be considered to be contributions and if the owner of the IRA is not eligible to make a contribution, it will be considered an excess contribution subject to the 6% excise tax on an annual basis (unless and until withdrawn).

3. None of the following services can be performed by the IRA owner:

    a. Repairs and maintenance cannot be performed by the IRA owner.

    b. Rents cannot be negotiated and collected by the IRA owner.

4. If debt is used to acquire a property, earnings are subject to unrelated business income tax (UBIT) and require the filing of a Form 990-T.

UNRELATED BUSINESS TAXABLE INCOME (UBTI) [IRC SEC(S). 511 THROUGH 514]

A retirement plan can own directly or indirectly a trade or business. However, a taxpayer may find the income from the trade or business that is "not substantially related to" is unrelated business income (UBI) and subject to tax.

Not substantially related to means the activity producing income does not contribute importantly to the exempt purpose of the organization, other than its need for funds. Whether an activity contributes importantly depends on the facts involved. IRS Publication 598, Tax on Unrelated Business Income of Exempt Organizations, provides additional clarification.

If an IRA has the following, it may constitute unrelated business taxable income (UBTI):

1. Income derived from a trade or business activity.

2. A business activity that is not substantially related to the tax-exempt purpose of the IRA.

3. Business is regularly carried on by the IRA.

4. Capital gains from debt-financed property under IRC Sec. 514.

OBSERVATION: IRS has been auditing retirement plans with master limited partnership (MLP) and publicly traded partnership (PTP) holdings at an increasing rate to determine compliance with filing requirements of Form 990-T. The word has gotten out to the industry as fiduciaries are requesting information and preparing these returns for the retirement trust as required by statute more frequently. It should be noted that there are several issues associated with this filing. First, the taxpayer may have multiple plans, with multiple trustees, which must be aggregated. Second, the trustee is the party responsible for the Form 990-T filing (i.e., reviewing and signing) a return that can be very complicated. Third, owners/beneficiaries need to be aware of the associated complications of these types of investments in their retirement accounts. Carefully review the Schedule K-1s received by the client for proper inclusion by the retirement trusts.

In February 2021, TIGTA released a report offering eight recommendations to help improve guidance, address compliance issues and safeguard against reporting material errors related to UBI. The IRS now plans on informing taxpayers, in appropriate cases, of the potential risks of not complying with their UBI filing requirements, evaluating claim thresholds sent to the field, and exploring opportunities to improve the accuracy of UBI examination results information reporting.

UBTI earnings can be found in limited partnerships, limited liability companies, master limited partnerships, and any investment that has debt financing and is involved in an unrelated business enterprise.

The type of earnings that are not generally UBTI are—

1. Interest, dividends, and royalties.

2. Rental income that is not debt-financed; UBTI will be in direct proportion to the portion that is debt-financed.

3. The sale of assets, except those items under IRC Sec. 514.

When UBTI in a taxpayer's IRAs exceeds $1,000, Form 990-T is required to be filed:

1. Form 990-T is due on or before April 15.
2. Payment of tax must be paid from assets of the IRA.
3. Filers of Form 990-T are required to submit estimated payments if the expected liability is greater than $500.
4. All IRAs of a taxpayer are aggregated for purposes of filing Form 990-T.

LAW CHANGE ALERT: The minimum penalty for late filing (greater than 60 days) is the smaller of the tax due or $435; otherwise, the late-filing penalty will be 5% of unpaid tax for each month up to a maximum of 25%. See additional details on late payment penalties in Chapter 4.

EXCESS CONTRIBUTIONS

A 6% excise tax is imposed if excess amounts are contributed to a qualified plan, such as an IRA, Roth IRA, or individual retirement annuity (IRC Sec. 4973). The excess contribution excise tax applies if excess amounts are not withdrawn prior to the filing due date of the return, including extensions [IRC Sec. 4973(b)]. This 6% excise tax is assessed for every year that the excess has not been removed.

Prior-year IRA excess contributions can be corrected without taking a distribution by applying them to later years' contributions. This does not avoid the 6% penalty for the prior year.

DEFERRAL LIMITS FOR PARTICIPANTS IN MULTIPLE PLANS

An employee may be a participant in multiple employer plans, but the limits of participation are aggregated.

Employees who work for more than one employer or who have switched jobs may find themselves in the position of excess contributions and must make appropriate adjustments to correct any over-contribution amount.

An employee who has made excess deferrals should notify the plan trustee and request a withdrawal of the excess deferral:

1. The plan must pay out the excess amount (plus any earnings) as instructed by the employee by April 15th.
2. Amounts withdrawn by April 15th will not be included in the income of the employee for the withdrawal year.
3. Income earned on withdrawal amounts is reported in the year of withdrawal.
4. If the excess deferral amounts are not withdrawn by April 15th, those excess amounts will not reduce the income of the employee for the deferral year and will be income when the amount is withdrawn at a later date, because excess deferral amounts cannot add to a plan's basis.

2021 Pension Plan Comparability Table

Plan Characteristic	Money Purchase IRC Sec. 401	Profit Sharing IRC Sec. 401	401(k) IRC Sec. 401	IRA IRC Sec. 408	SIMPLE IRA IRC Sec. 408	SEP IRC Sec. 408
Maximum deductible plan deposit per code	Lesser of $58,000 or 25% of compensation IRC Sec. 415 (Also see limits, below)	Lesser of $58,000 or 25% of compensation IRC Sec. 415 (Also see limits, below)	Lesser of $58,000 or 25% of compensation IRC Sec. 415 (Also see limits, below)	N/A	Employee amount + lesser of 3% of compensation or employee deferral	Lesser of $58,000 or 25% of compensation IRC Sec. 415 (Also see limits, below)
Maximum employee deposit	N/A	N/A	Lesser of $19,500 or 100% of compensation	Lesser of $6,000 or 100% of compensation	Lesser of $13,500 or 100% of compensation	N/A
Over age 49 catch-up contribution (over and above otherwise allowable maximum)	N/A	N/A	$6,500	$1,000	$3,000	N/A
Form 5500 required?	Yes	Yes	Yes	No	No	No
Other qualified plans allowed?	Yes	Yes	Yes	See MAGI limits	No	Yes
Mandatory employer contributions	Yes	No	No	N/A	Yes	No
Minimum age/service	Age 21, up to 2 years	Age 21, up to 2 years	Age 21, up to 2 years, but employee deferrals allowed after 1 year	N/A	All earning more than $5,000 in any prior 2 years, and expecting $5,000 in current year	Age 21, any 3 of last 5 years, and earning more than $600 in current year
Top-heavy rules apply?	Yes	Yes	Yes	No	No	Yes
Nondiscrimination rules apply?	Yes	Yes	Yes	No	No	No
IRC Sec. 415 limits apply?	Yes	Yes	Yes	N/A	No	Yes

Plan Characteristic	Money Purchase IRC Sec. 401	Profit Sharing IRC Sec. 401	401(k) IRC Sec. 401	IRA IRC Sec. 408	SIMPLE IRA IRC Sec. 408	SEP IRC Sec. 408
Vesting?	Yes– graduated	Yes– graduated	Yes– graduated, 100% immediate for employee contributions	Yes–100% immediate	Yes–100% immediate	Yes–100% immediate
Last day to establish	Tax Return Due dater	Tax Return Due Date	December 31 of current year Solo 401(k) exception	April 15 of following year	October 1 – current year Sole Proprietorship Exception	Due Date plus extension
Last day for employer to deposit	Due Date plus extension	Due Date plus extension	Due Date plus extension	April 15 of following year	Due Date plus extension	Due Date plus extension

CARES ACT SPECIAL DISTRIBUTION PROVISIONS AFFECT YEARS 2020–2022

There were provisions of the CARES Act that affected distributions and loans during 2020 for 2021 and 2022:

- Coronavirus-related retirement plan distributions:
    a. Three-year pro-rata income inclusion.
    b. Three-year recontribution window.

Any individual receiving such qualifying distribution must have met the definition of a qualifying individual. They must either have been—

1. Diagnosed with the SARS-CoV-2 virus or with coronavirus disease (COVID-19) by a test approved by the Centers for Disease Control and Prevention (CDC), or
2. Someone whose spouse or dependent was diagnosed with such virus or disease by such a test, or
3. Someone who experienced adverse financial consequences as a result of being quarantined, being furloughed, or laid off work. They may have had hours reduced due to such virus or disease, been unable to work due to lack of childcare due to such virus or disease, closed or reduced hours of a business owned or operated by the individual due to such virus or disease, or other factors.

The aggregate amount of distributions received by an individual which may have been treated as coronavirus-related distributions for any tax year could not exceed $100,000. To the extent distributions exceed the threshold they will be treated as a non-coronavirus distribution.

A taxpayer may have decided to pay the tax on the distribution in one of two ways:

- For 2020–2022, include ⅓ of the eligible distribution in income.

EXAMPLE: Treatment of COVID-19-related distribution

The taxpayer received a COVID-19-related distribution in the amount of $30,000 in 2020.

Scenario 1: An amount equal to ⅓ of $30,000 (i.e., $10,000) will be included in each of the following three years: 2020, 2021, and 2022. This was the default and required no election.

Scenario 2: The taxpayer elected to include the entire $30,000 as income in 2020, this required an election be made with the return.

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- A distribution can be recontributed back to a retirement plan. Any individual who receives a coronavirus-related distribution may, at any time during the three-year period beginning on the day after the date on which such distribution was received, may make one or more recontributions in an aggregate amount. not to exceed the amount of such distribution to an eligible retirement plan of which such individual is a beneficiary and to which a rollover contribution of such distribution could be made.

- When a taxpayer recontributes COVID-related distributions in future years, they may either carryback or carryforward amounts in excess of any current year inclusion amounts:

EXAMPLE: Treatment of recontributing COVID-related distributions

The taxpayer in 2021 after filing their 2020 return, recontributed $15,000 to a qualified retirement account.

Scenario 1: The taxpayer reduces their includable Corona virus related distribution of $10,000 in 2021 by $10,000 and elects to carryback the remaining $5,000 to 2020 filing an amended return.

Scenario 2: The taxpayer reduces their includable Corona virus related distribution of $10,000 in 2021 by $10,000 and elects to carryforward the remaining $5,000 to 2020 filing an amended return.

Scenario 3: The taxpayer reduces their includable Corona virus related distribution of $10,000 in 2021 by $7,500 and carries forward the remaining $7,500 reducing the includable amount(s) in 2021 and 2022 of $10,000 by $7,500 in each year.

TRADITIONAL IRA DISTRIBUTIONS

Deductible and nondeductible IRAs are considered traditional IRAs. All distributions from traditional IRAs, with the exception of the portion attributed to nondeductible contributions, are taxable and potentially subject to an excise tax.

The nontaxable portion of a current year traditional IRA distribution is calculated as follows:

$$\frac{\text{Total Nondeductible contributions}}{\text{FMV of All Traditional IRA Account Balances at Year-End} + \text{Amount Distributed During Year} + \text{Outstanding Rollover}} \times \text{Traditional IRA Distributions} = \text{Nontaxable Portion of Traditional IRA Distributions}$$

The year-end FMV of all traditional IRA accounts used in the denominator includes IRC Sec. 408 plans including SEP and SIMPLE IRAs, but not ROTH IRAs under IRC Sec. 408A. Community property laws do not apply to IRA distributions [IRC Sec. 408(g)].

EXAMPLE: Calculating return of basis portion

Flip has two traditional IRA accounts. In the past, Flip made a deductible contribution of $3,000 into IRA #1 and he made nondeductible contributions in the amount of $3,000 to IRA #2. During the year, Flip withdrew $3,000 from IRA #2 thinking it would not result in taxable income. At the end of the year, Flip had balances of $4,000 in IRA #1 and $500 in IRA #2. Unfortunately for Flip, only $1,200 of his total distributions is treated as a nontaxable return of basis and $1,800 is a taxable distribution. The return of basis portion is calculated as follows:

$$\frac{\$3{,}000}{\$4{,}000 + \$500 + \$3{,}000} \times \$3{,}000 = \$1{,}200$$

Note: Taxpayers, such as Flip, who have taken distributions, including a return of basis for nondeductible contributions, should delay rollovers from an employer plan until the following year, because rollover amounts made during the current year are added to the denominator and further dilute any nontaxable return of basis.

TCJA IMPACT: Unrecovered basis in an IRA is no longer deductible due to the elimination of miscellaneous itemized deductions subject to the 2%-of-AGI limitation [IRC Sec. 67(g)]. This provision affects tax years beginning after December 31, 2017, and before January 1, 2026.

ROTH IRA DISTRIBUTIONS

A distribution from a Roth IRA *is not* taxable if it is—

1. A return of the owner's original Roth IRA contributions [IRC Sec. 408A(d)(2)(C)], or
2. A qualified distribution (see below), or
3. Rolled over to another Roth IRA.

No portion of a distribution from a Roth IRA is taxable until the cumulative distribution from all Roth IRA accounts exceeds the total amount of contributions. Therefore, regular contributions can be withdrawn tax-free and penalty-free at any time.

For the purpose of determining the taxation of Roth IRA distributions, all Roth IRA accounts are aggregated. Distributions are determined as of the end of the taxable year and in the following order (each category is exhausted before moving on to the next category):

1. From regular contributions,
2. From conversion contributions, on a FIFO basis, and
3. From earnings.

Distributions from a particular conversion are treated as being made first from the portion, if any, that was includable in gross income.

Roth IRA Withdrawal Rules—Summary

Type of Withdrawal	Subject to Income Tax?	Subject to 10% Penalty?
Contributions	No	No
Conversions	No	Yes—unless Exception 1
Earnings	Yes—unless Exception 2	Yes—unless Exception 3

- **Exception 1:** Five Years or meets the Section 72(t) exception for IRA [Reg. §1.408A-6 (Q&A 5)].
- **Exception 2:** Five Years and >59½, or deceased, or disabled, or first-time homebuyer.
- **Exception 3:** Five Years and meets Section 72(t) exception for IRA.

ROTH IRA QUALIFIED DISTRIBUTIONS

A *qualified distribution* is a distribution that is made after a five-taxable-year period (see definition below) and at least one of the following [IRC Sec. 408A(d)(2)]:

1. Made on or after the date the owner attains age 59½,
2. Made to a beneficiary or the estate of the owner on or after the date of the owner's death,
3. Attributable to the owner's being disabled, or
4. Used under the first-time home purchase provision.

The five-year taxable period for qualified distributions begins on the first day of the tax year for which the first regular contribution is made to any Roth IRA, or, if earlier, the first day of the tax year of the first conversion contribution. It ends on the last day of the individual's fifth consecutive tax year.

EXAMPLE: Treatment of Qualified Roth IRA Distribution

Tom, age 60, made his first contribution of $2,000 to a Roth account in April 2017 for the 2016 tax year. In January 2021, Tom withdraws the entire balance from his ROTH IRA. Tom's entire distribution (including earnings) is qualified and tax-free because he has met the 5-year period and is over age 59½. The 5-year period began on January 1, 2016 and ended on December 31, 2020.

Note: Tom can remove all his original contributions from his Roth IRA at an earlier date without incurring a tax liability or penalty.

Distributions to a beneficiary that are not qualified distributions are includable in the beneficiary's gross income.

PLANNING TIP: The 5-year period for conversions can be a trap for taxpayers who have converted larger sums and have a need for those funds prior to the fifth year as the 10% excise penalty may apply.

Any nonqualified distributions that exceed an owner's basis of all of their Roth IRAs are taxable. The 10% penalty tax under IRC Sec. 72(t) applies (unless an exception is met) to any distribution from a Roth IRA that is includable in gross income.

ROTH IRA DISTRIBUTIONS FROM CONVERSIONS

The 10% penalty tax applies to the extent it is allocable to a conversion contribution if a distribution is made within the five-taxable-year period beginning with the first day of the individual's taxable year when the conversion contribution was made. The exceptions under IRC Sec. 72(t) also apply to such a distribution (i.e., death or age 59½).

The five-taxable-year period is separately determined for each conversion contribution and is not the same as the five-year period used to determine qualified distributions. This is not widely known and is a trap for those who planned on using the funds prior to age 59½. They must wait the full five years or until reaching 59½.

EXAMPLE: Treatment of Roth IRA distribution from conversion

Jim, age 55, converted $100,000 from a traditional IRA to a Roth IRA during 2018. He previously had contributed $3,000 into a Roth IRA back in 2008. He intends to take out most of it during 2021 to purchase a mountain retreat. He realizes any earnings could be subject to tax and penalty but assumes the converted amount is free from the 10% penalty tax.

A distribution attributable to the taxable portion of a conversion contribution may be subject to the 10% premature distribution penalty tax if the distribution is made during the five-year period beginning with January 1 of the year of that particular conversion contribution, unless one of the exceptions to the 10% penalty applies. Here, Jim will pay the 10% penalty tax not only on the earnings but also on the $100,000 he had converted.

ROTH IRA MISCELLANEOUS PROVISIONS

Basis equals Roth IRA contributions, plus conversions, less any previous nontaxable distributions. Unrecovered basis of a Roth IRA after 100% of account balance is withdrawn no longer can be deducted due to the elimination of miscellaneous itemized deductions subject to the 2% AGI limitation.

Participating in an employer-sponsored retirement plan does not prevent an individual from contributing to a Roth IRA.

REQUIRED MINIMUM DISTRIBUTION (RMD) CALCULATIONS

There are two sets of RMD rules that are calculated and distributed separately. Potentially an individual could be subject to either, or both, sets of rules:

1. Lifetime distribution rules apply to account owners, and
2. Beneficiary distribution rules apply to inherited accounts (including inherited ROTH IRA accounts).

Lifetime distribution rules generally become effective when an individual attains:

- Age 72 for those becoming 72 after 12/31/2019
- Age 70 ½ for those becoming 70 ½ prior to 01/01/2020

Taxpayers who fail to comply with the minimum distribution rules are subject to a 50% excise tax. A beneficiary of any age is subject to the beneficiary distribution rules. An RMD is calculated separately for each qualified plan and IRA. The respective RMD must be distributed from each type of plan. An RMD from a Section 403(b) plan can be combined and come out of any Section 403(b) plan [Reg. §1.403(b)-6(e)(7)].

The RMD for all a taxpayer’s aggregated IRA accounts can come out of any owned IRA. However, the RMD for IRA amounts held as an owner cannot be aggregated with amounts held as a beneficiary. Accounts held as a beneficiary from the same decedent can be aggregated but amounts from differing decedents may not be aggregated for this purpose [Reg. §1.408-8 (Q&A9); IRS Notice 88-38]. SEP and SIMPLE IRAs are treated as IRAs for this purpose [Reg. §1.408-8 (Q&A2)].

Each year’s RMD is calculated independently. If the amount distributed exceeds the minimum required, no credit is given in subsequent calendar years for such excess distribution [Reg. §1.401(a)(9)-5, Q&A-2].

LIFETIME REQUIRED MINIMUM DISTRIBUTION

These rules apply to all stock bonus, pension, profit-sharing plans, Section 403(b) plans, deferred compensation plans (under IRC Sec. 457), and traditional IRAs. An owner’s Roth IRA accounts are not subject to the lifetime RMD rules.

PLANNING TIP: All inherited accounts, including inherited Roth IRAs, are subject to a separate set of rules and are not included as part of this calculation.

Benefits must be distributed, or start being distributed, no later than the required beginning date (RBD). The RBD for lifetime distributions is normally:

1. All Section 408 accounts, including IRAs, SEPs, and SIMPLE IRAs, fall under the rule that distribution must be made April 1st of the calendar year following the year in which a participant reaches age—

   - 70½ (for those who attained age 70½ *prior* to 01/01/2020)

   - 72 (for those who attain age 70½ *after* 12/31/2019)

2. For qualified retirement plans (not IRAs), the RBD is dependent on a participant's ownership in the employer and continued employment:

   a. For participants who are not more-than-5% owners in an employer, the RBD can be delayed until the later of April 1st following the year the employee reaches age 70 1/2/72 or retires from the employer.

   b. A 5% or more owner of a business (as defined in IRC Sec. 416) must start taking distributions no later than April 1st of the year following the calendar year the owner reaches age 70½ / 72.

The RBD for Section 403(b) plans is generally the same as it is for plan participants. However, special rules apply to some Section 403(b) plans that allow for the delay of pre-1987 account balances until a participant reaches age 75.

EXAMPLE: Determining a Section 403(b) plan's RBD

Scenario 1: Tim was born on July 1, 1949. Since Tim did not reach age 70½ before January 1, 2020, he is subject to the rules of the SECURE Act. Tim will turn 72 in 2021, and so his RBD will be April 1, 2022.

Scenario 2: Rick was born on June 30, 1949 and will thus reach age 70½ on December 30, 2019. Because he reached age 70½ prior to January 1, 2020, his RBD will be April 1, 2020 (due to the CARES Act, Rick's first RMD will not be required until 2021.)

Generally, the first distribution calendar year is the year in which the participant attains age 70½ / 72 or retires [Reg. §1.401(a)(9)-5, A-1(b)]. Although the RBD is not until the following April 1st, a distribution made on this date is considered for the prior year (or age 70½ / 72 year). Accordingly, if a taxpayer waits until April 1st, a second RMD must be taken by December 31st to meet the current-year RMD requirement. Doubling the distribution in the first year can have a detrimental effect on the taxation of social security, Medicare B and D premiums and other AGI/MAGI sensitive calculations, as follows:

1. If the first RMD is delayed until the RBD, the account balance is decreased by distributions made in the valuation calendar year after the valuation date [Reg. §1.401(a)(9)-5, Q&A-3(c)].

2. For all subsequent years, an RMD must then be taken by December 31st [Reg. §1.401(a)(9)-5, Q&A-1(c)].

Calculating a Required Minimum Distribution—Life Expectancy Payout Method

Calculate the account balance as of December 31st of the preceding year. A reconciliation similar to a cash reconciliation is done to account for amounts in transit.

Divide the account balance by the appropriate life expectancy divisor using the age the participant will attain on his birthday for the year of distribution. If the distribution is for this year, the age the taxpayer will attain during this year is used:

1. For married individuals whose spouse is the sole beneficiary and is more than 10 years younger, use the joint and last survivor tables. [See Appendix B in IRS Pub. 590-B, Table II. or Reg. §1.401(a)(9)-9.] This is beneficial as it calculates a lesser RMD. If the designated beneficiary is changed to anyone other than a spouse through death or divorce, this table cannot be used in the year after the change [Reg. §1.401(a)(9)-5, A-4(b)(2)].

2. In all other instances, use the Uniform Lifetime Table. [See Appendix B in IRS Pub. 590-B, Table III or Reg. §1.401(a)(9)-9.]

If an account value has decreased below the calculated minimum based on the December 31 balance, the account can be depleted with no 50% penalty for not taking the full required distribution.

EXAMPLE: Calculating an RMD using life expectancy payout method

During the year, Jon turned 81, his wife Lynn turned 65, and his daughter turned 32. Following is a summary of Jon's IRA accounts:

IRA	Beneficiary	Table	Life Expectancy	Account Balance 12/31/20	2021 RMD
IRA 1	Estate	Uniform Lifetime	19.4	$500,000	$ 25,773
IRA 2	Lynn	Joint	23.7	$500,000	21097
IRA 3	Daughter	Uniform Lifetime	19.4	$10,000	515
IRA 4	Daughter	Uniform Lifetime	19.4	$50,000	2,577
					$ 49,962

Note: While an RMD for each IRA account is calculated separately, Jon can choose to take his RMD out of any one or more of his individual IRA accounts. However, an RMD for any other account must be withdrawn from that account, i.e., the beneficiary account can only be taken from the beneficiary account.

On November 6, 2020 the IRS issued final regulations that updated the life expectancy and distribution period tables used for purposes of determining required minimum distributions. The final regulations apply to distribution calendar years beginning on or after January 1, 2022.

	Uniform Lifetime Table		Single Lifetime Table	
Age	**Current**	**2022 and Beyond**	**Current**	**2022 and Beyond**
72	25.6	27.4	15.5	17.2
73	24.7	26.6	14.8	16.4
74	23.8	25.5	14.1	15.6

BENEFICIARIES AND REQUIRED MINIMUM DISTRIBUTIONS

Taxpayers who inherit retirement accounts are subject to a separate set of RMD rules. All inherited accounts, including ROTH IRAs, are included.

The RMD for an inherited account is calculated differently depending on whether the owner dies before or after their RBD. ROTH owners are always treated as dying before their RBD for owners deceased prior to 01/01/2020.

As a result of the SECURE Act, there are two separate sets of beneficiary distribution rules: one for decedents who died prior to 01/01/2020 and another for those who died after 12/31/2019. Note there are examples of both in the manual.

PLANNING TIP: The 10% excise tax for premature distributions never applies to distributions made after the owner's death no matter the age of the beneficiary.

INHERITED ACCOUNT RMD WHEN OWNER DIES PRIOR TO THEIR RBD (DATE OF DEATH PRE-2020)

Spouse is beneficiary

If a spouse is the beneficiary, they may:

1. Treat the IRA as his/her own designating themselves as the account owner,
2. Take the entire balance by the end of the 5th year following year of death, or
3. Distribute the IRA based on Table I of Publication 590-B using the spouse's current age each year. Distributions do not have to begin until the owner would have turned age 70½ / 72.

CAUTION: The election allowing a spouse to treat an inherited IRA as his own can be made at any time after the date of death [Reg. §1.408-8, A-5(a)]. If a spouse elects to treat the retirement account as their own, the account no longer qualifies for an Section 72(t) death exception. This could be costly to a spouse younger than 59½ who needs access to the funds and fails to meet any other of the 10% penalty exceptions.

Remember also to consider the effect of *Clark v. Rameker, et al* [(113 AFTR 2d 2014-2308) (34 S. Ct. 2242)]; if the spouse fails to convert the account to their own it may potentially be subject to claims of bankruptcy claimants. For all beneficiaries, required distributions begin (at the earliest) in the calendar year following the year of an owner's death.

Non-Spouse Is Beneficiary

If a non-spouse is the beneficiary, they may—

1. Distribute the IRA based on Table I of Publication 590-B using the beneficiary's age at year-end following year of owner's death and then reduce the beginning life expectancy by 1 for each subsequent year, or

2. Take the entire balance by the end of the fifth year following year of death,

A qualifying trust may take an RMD over a period not longer than the life expectancy of the oldest beneficiary.

No Beneficiary

If there is no designated beneficiary, the entire account must be distributed by the end of the fifth year (five-year rule) following the year of the owner's death. This includes beneficiaries (one or more) that are not qualified beneficiaries (e.g., an estate or charitable organization). Distributions are not required until the fifth year [Reg. §1.401(a)(9)-3, A-2, A-4].

INHERITED RMD WHEN OWNER DIES AFTER RBD (DATE OF DEATH PRE-2020)

The RMD for the year of a taxpayer's death is not avoided because the account owner dies before actually taking it. Instead, the RMD is computed one last time using the RMD rules that apply before death and must be distributed to the account beneficiary before the end of the year of the owner's death.

Spouse Is Beneficiary

If a spouse is the beneficiary, they may:

1. Treat the account as his/her own; or

2. Distribute over spouse's life using Table I from Publication 590-B using spouse's current age each year; or

3. Distribute based on owner's age using Table I from Publication 590-B using owner's age as of birthday in year of death, reducing beginning life expectancy by one year for each subsequent year or take the owner's RMD for year of death.

Non-Spouse Is Beneficiary

Non-spouse beneficiaries must take distributions over their life expectancy using the Single Life Table. If the designated beneficiary is older than the participant, the designated beneficiary can use the participant's remaining life expectancy [Reg. §1.401(a)(9)-5, A-5(a)(1)].

When a named beneficiary receives a retirement account upon the death of the owner, the beneficiary can take distributions:

1. Based on the decedent's life expectancy, or

2. Based on the single life expectancy of the beneficiary.

Unlike an account owner, a beneficiary is required to reduce the life expectancy timeframe by one year each year.

No Beneficiary

If there is no designated beneficiary, an RMD must be taken over the life expectancy of the participant as of the year of death, reduced by one year for each subsequent year [Reg. §1.401(a)(9)-5, A-5(a)(2) and (c)(3)].

INHERITED RMD RULES WHEN OWNER DIES AFTER 12/31/2019

LAW CHANGE ALERT: Under the SECURE Act, the general rule is that after an employee (or IRA owner) dies, the remaining account balance must be distributed to designated beneficiaries within 10 years after the date of death. The distribution rules apply without regard to the RBD of the deceased owner.

There are several exceptions to the general rule in place for owners dying after December 31, 2019. Those who are not subject to the 10-year rule are—

1. the surviving spouse of the employee or IRA owner, or
2. a child of the employee or IRA owner who has not reached majority, or
3. a disabled individual within the meaning of IRC Sec. 72(m)(7), or
4. a chronically ill individual as specially defined in IRC Sec. 401(a)(9)(E)(ii)(IV), or
5. any other individual who is not more than ten years younger than the employee or IRA owner.

Note that once any of the preceding exceptions ceases to apply, the account will be subject to the 10-year rule. Those who are excepted, are not subject to the current distribution rules until they no longer meet one of the exceptions as indicated in Item 3 or 4 above.

EXAMPLE: Treatment of RMD depending on owner's date of death

Scenario 1: Anne dies in 2021 and leaves her IRA to designated beneficiary Ben, her brother, who was born eight years after Anne. Ben is an eligible designated beneficiary, and the balance in the IRA at Anne's death may be paid over Ben's life or life expectancy. If Ben dies before the IRA account is exhausted, the remaining balance must be paid out within 10 years after Ben's death without regard to the above exceptions.

Scenario 2: Chad dies in 2021 and leaves his IRA to designated beneficiary Dee, his sister who was born 12 years after Chad. Dee is not an eligible designated beneficiary because she is more than 10 years younger than Chad, and the balance in the IRA at Chad's death must be paid out within 10 years after Chad's death.

Scenario 3: Jack died on 11/01/2019, but his retirement accounts were not distributed to his beneficiaries until 07/01/2020. The beneficiaries are subject to the rules prior to the SECURE Act; i.e., they can stretch out their distributions over their Single Life because Jack died prior to 01/01/2020.

DESIGNATED BENEFICIARIES (DATE OF DEATH PRE-2020)

Only a designated beneficiary who is a "natural person" can elect to take an RMD over their own lifetime.

An estate *is not* a designated beneficiary. However, a surviving spouse and sole residuary beneficiary of an estate may roll over an IRA to his spousal IRA as though the proceeds were received directly from the IRA [PLR 200236052].

A designated beneficiary does not need to be specified by name as long as the individual is identifiable according to the plan document [IRC Sec. 401(a)(9)(E); Reg. §1.401(a)(9)-4, A-1]. For example, "my spouse and children" satisfies the requirement.

A beneficiary must be a named beneficiary as of the date of death; beneficiaries cannot be added or replaced even if named in a will.

Beneficiaries can be eliminated for purposes of determining who is designated by—

1. Disclaimer notifying the custodian within nine months after the participant's death [IRC Sec. 2518(b)(2)], or

2. Distributing their share by September 30th of the year following death.

PLANNING TIP: Encourage clients to name contingent beneficiaries. Often a spouse is named as the primary beneficiary with no contingent beneficiaries listed. Naming contingent beneficiaries allows for more planning options where the spouse predeceases, dies simultaneously, or dies shortly after the account owner. If there is no named beneficiary, the estate will be the beneficiary, the estate is not a qualified beneficiary for RMD.

If a beneficiary dies during the period between the date of the account owner's death and the designation date of beneficiaries, required distributions are calculated using the life expectancy of the beneficiary (as if designated) [Reg. §1.401(a)(9)-4, A-4(c)].

Beneficiaries that receive a distribution in the year of death are eligible to disclaim. They may disclaim by September 30 in the year following death even if they have received a distribution in the year of the decedent's death [Rev. Rul. 2005-36].

MULTIPLE BENEFICIARIES AND SEPARATE ACCOUNTS (DATE OF DEATH PRE-2020)

If more than one beneficiary is designated and all are individuals, RMDs are based on the age of the oldest beneficiary [Reg. §1.401(a)(9)-5, A-7].

Separate accounts must be established by December 31 of the year following the year of death for beneficiaries to individually use their own life expectancy [Reg. §1.401(a)(9)-8, A-2(a)(2)]. Post-death investment gains and losses are allocated to the separate accounts on a pro rata basis [Reg. §1.401(a)(9)-8, A-3].

Pecuniary gifts (specific dollar amounts or units to beneficiaries) that do not share in investment gains and losses after death do not qualify for separate accounts.

If an account is not separated and beneficiaries include parties that are not qualified RMD beneficiaries (e.g., a charity), the account could be subject to the five-year rule (i.e., required complete distribution by the end of the fifth year following the year of the owner's death).

TRUST AS BENEFICIARY (DATE OF DEATH PRE-2020)

Beneficiaries of a trust can be considered designated beneficiaries and allowed to use the life expectancy method if all requirements are met [Reg. §1.401(a)(9)-4, A-5]:

1. Trust is valid and irrevocable upon death under state law.
2. Beneficiaries must be identifiable from the trust document and must be individuals. The life expectancy of the oldest beneficiary is used to calculate an RMD after a participant's death.

A beneficiary can be disregarded in determining the oldest beneficiary if the individual is a successor to the interest of another beneficiary [Reg. §1.401(a)(9)-5, A-7(c)(1)].

In PLR 201523019, the IRS ruled that a Section 401(k) account balance left in trust to a spouse could be rolled to her IRA, but only because it was a joint living trust and the spouse was sole beneficiary. If a trust had been named beneficiary, even if the spouse was sole beneficiary of the trust, a rollover would not be allowed [Reg. §1.408-8, A-5(a)].

NOTE: In PLR 201707001, the IRS determined that a spouse who was the sole trustee and beneficiary of a trust was allowed to either roll over the IRAs to her own account or leave them in the name of the deceased.

Separate accounts for beneficiaries cannot be created for an RMD unless the trust is to be immediately divided into separate trusts after the participant's death (PLR 200234074).

Trustees and custodians are required to report RMDs for a calendar year for an IRA on Form 5498.

PLANNING TIP: In PLR 201944003, the IRS once again ruled that a spouse who was the sole beneficiary of a conduit trust was the owner of the retirement plan assets, and thus accorded spousal benefits. While most experts in the field believe this answer has not changed as a result of the SECURE Act, the consequences of being wrong are quite expensive. As previously discussed, reviewing trust documents should be a priority process due to the new act.

OBSERVATION: Due to the retroactive nature of the change associated with the SECURE Act, immediate attention should be given to retirement accounts using trusts to effect post death transfers. Special attention should be given to the Conduit Trusts and the Accumulation Trust, which, while restricted for payouts, will not change the tax effects of the new rules. A review of transfers being made by trusts at the death of the owner should be reviewed soon.

SPOUSAL CONSENT RULES APPLY TO QUALIFIED PLANS

Beneficiary designations for qualified plans are subject to "spousal consent rules." Married qualified plan participants must name their spouse beneficiary unless the spouse consents in writing to the naming of another beneficiary. These rules do not apply to IRAs.

A spouse's consent must acknowledge the effect of the designation. It must be notarized or witnessed by a plan representative. This applies to all qualified plans. A spouse's consent is binding only upon that spouse. If a spouse dies or the couple divorces, and the participant later remarries, consent is not binding on the new spouse [Reg. §1.401(a)-20, Q-29]. A prenuptial agreement (i.e., an agreement entered into before marriage) *does not* satisfy spousal consent requirements [Reg. §1.401(a)-20, Q-28].

OBSERVATION: If the taxpayer's spouse agrees to sign the waiver, which should be provided by the firm that administers the 401(k) plan, a plan representative or a notary public must act as a witness. A prenuptial agreement cannot take the place of a waiver; the law says the spouse (not soon-to-be-spouse) must sign. A spouse who *does* sign a waiver can withdraw that consent if the other spouse later names a different beneficiary unless the signing spouse expressly gave up that right. [IRC Sec. 417(a)(2)]

COVID-19 UPDATE: In response to the COVID-19 pandemic, the IRS issued Notice 2020-42 to provide temporary relief from the physical presence requirement for any participant election witnessed by a notary public of a state that permits remote electronic notarization. Temporary relief from the physical presence requirement is also granted for any participant election witnessed by a plan representative. The temporary relief is available January 1, 2020–December 31, 2020.

Spousal Consent for Distributions

If a qualified plan is subject to the survivor annuity rules, married participants must receive their benefits in the form of a qualified joint and survivor annuity or qualified preretirement survivor annuity unless the spouse consents, in writing, to another form of distribution. In other words, a married participant in a qualified plan cannot elect to receive a lump sum distribution unless his spouse consents to the distribution.

Designated Beneficiary Summary

Designated Beneficiary	Participant Dies before RBD	Participant Dies after RBD
Spouse	RMD postponed until later of— 1. Year following participant's death, 2. Year participant would have attained 70½ (or 72), or 3. End of fifth year after the participant's death, if the plan permits and the surviving spouse elects. 4. RMD over spouse's life expectancy as determined each year from single life table (unless five-year rule is used). 5. Rollover as own: leading to possible further deferral to a second generation.	RMD for year of death is based upon decedent's life expectancy using lifetime method. For years after death, RMD is based on the larger of— 1. The surviving spouse's life expectancy from the single life table using the spouse's attained age for year, distribution calendar year as recalculated each year, or 2. The life expectancy of the deceased spouse under the single life table using the age of the deceased spouse for the year of death and reduced by one each year after the year of the first distribution (term certain). 3. Rollover as own.
Non-spouse	1. RMD pre-2020 deaths is determined based on the life expectancy factor for the designated beneficiary determined by the single life table. First distribution is made in the year following the year of death. The factor is reduced by one year each year thereafter. 2. Or, distributions must be completed by the end of the fifth year following participant's death. 3. Rollover to an "inherited IRA" available if made timely as a direct transfer.	1. RMDs over the beneficiary's single life expectancy (determined as of December 31 after the year of death) and reduced by one each year thereafter, or if longer, the owner's remaining single life expectancy (reduced by one each year). 2. Rollover to an "inherited IRA" available if made as a direct transfer on a timely basis.

Designated Beneficiary	Participant Dies before RBD	Participant Dies after RBD
Trust	1. RMD for pre-2020 deaths over life of oldest trust beneficiary beginning in year following year of death if trust qualifies as a designated beneficiary. 2. If trust does not qualify, distribution must be made by the end of the fifth year following participant's death.	1. If trust qualifies as a designated beneficiary, distributions continue over life expectancy of the oldest beneficiary. 2. If trust does not qualify as a designated beneficiary. See rules for no beneficiary below.
No designated beneficiary (Estate or Charity)	1. Distributions must be completed by end of fifth year following participant's death. 2. Possible spousal rollover if spouse is sole beneficiary of the estate.	1. Owner's single life expectancy calculated in year of death reduced by one each year thereafter. 2. Possible spousal rollover.

Spousal Consent for Plan Loans

If a plan is subject to the survivor annuity rules, married participants cannot use their vested account balance as security for a loan without spousal consent.

ROLLOVERS—GENERAL RULES

A taxpayer has the ability to rollover from virtually any kind of plan into an IRA:

1. Distributions from an IRA can be rolled to a defined contribution (DC) plan if allowed by the plan.
2. IRAs can accept rollover distributions from any type of defined contribution plan.

There are certain types of distributions that cannot be rolled over:

1. Required minimum distributions (RMDs) and
2. Hardship distributions.

A surviving spouse can roll over an eligible rollover distribution from their deceased spouse's account.

While rollovers from other plans into an IRA are almost without limit, the same cannot be said for rollovers from various plans into an employer-sponsored defined contribution plan. Significant restrictions and limitations are placed on these types of rollovers:

1. Section 457 and 403(b) plans are not required to accept rollovers but may choose to do so.
2. An employer plan can allow rollovers from other plans, including IRAs, but are not required to do so.

Tracing rules apply that restrict the ability to access tax benefits, such as capital gain distributions, from a retirement plan. To preserve these benefits, the use of a conduit IRA is still necessary.

The Pension Protection Act of 2006 codified the right of a non-spouse beneficiary to rollover amounts from a deceased participant's qualified plan or IRA. The beneficiary may occasionally find a plan that prohibits this due to several confusing notices issued by the IRS.

As a result of the court case *Bobrow v. Comm.* (TC Memo 2014-21), an individual can make only one rollover in any 365-day period on an aggregate basis (not per account) [IRC Sec. 408(d)(3)(B)]. In IRS Letter Ruling 201647014, a determination was made that there are no exceptions to this rule. Notice 2020-51 modified the rollover rule:

1. The one year applies from the date the first IRA withdrawal is made.
2. The IRS has agreed to follow the court's application and laid out the framework for how they would treat distributions occurring on or after January 1, 2015, in IRS Announcements 2014-15 and 2014-32.
    a. A taxpayer can make rollovers from multiple accounts but will be required to "redeposit" all amounts within a single 60-day period.
    b. If a taxpayer takes a distribution after the first rollover deposit within a year, there will be no opportunity to complete another rollover and any subsequent distributions will be taxable.

A "trustee-to-trustee" transfer from one IRA to another IRA *is not* a rollover (Reg. §1.408-8, Q&A 8).

ROLLOVER PERIOD FOR QUALIFIED PLAN LOAN OFFSETS

Under IRC Sec. 72(p)(1), a loan from a "qualified employer plan" to an employee is treated as a plan distribution (referred to as a "deemed distribution") which may be taxable, unless the following conditions [described in IRC Sec. 72(p)(2)], are met:

1. The loan is required to be repaid within five years, except for certain home loans.
2. The plan loan is amortized in substantially level payments, made not less frequently than quarterly,
3. The amount of the loan, when added to the balance of all other plan loans to the employee, does not exceed a certain limit, and
4. The loan is evidenced by a legally enforceable agreement.

In the event any of the four conditions are not met or are no longer being adhered to, the unpaid balance of the loan is deemed to be distributed and subject to taxes and penalties as applicable. The trustee will report the "deemed distribution" on Form 1099-R.

A qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, an IRC Sec. 403(b) plan, or a governmental IRC Sec. 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's separation from service, whether due to layoff, cessation of business, termination of employment, or otherwise.

Under the TCJA, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution would be extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the tax year in which the plan loan offset occurs—that is, the tax year in which the amount is treated as distributed from the plan.

ROLLOVER OPTIONS FOR AFTER-TAX CONTRIBUTIONS

After tax contributions can either be—

1. Taken out of a plan during the total distribution process without tax consequence,
2. Rolled into an IRA (this will create basis in the IRA which should be tracked and reported on Form 8606), or
3. Rolled into another qualified retirement plan.

Any transfer must be made by direct rollover. The receiving plan must account for after-tax amounts in a separate account and account for the earnings on the after-tax contribution.

ROLLOVERS FROM IRAs

Any amount distributed from one IRA can be rolled over into the same account or another IRA if done within 60 days. There is no requirement that 100% of the distribution be rolled over; any amount up to the total distribution is allowed.

In the event of a failed acquisition by a first-time home buyer, 120 days are allowed rather than 60 days.

PLANNING TIP: If an IRA has tax basis, those basis amounts can only be rolled over to another IRA. A special rule, under IRC Sec. 408(d)(3)(H)(ii)(II), treats a distribution as including only taxable amounts, which allows a planning opportunity to leave amounts in an IRA with basis.

EXAMPLE: Determining rollover order

Jon has an IRA for which the following has occurred: (1) $100,000 of deductible contributions, (2) $30,000 of non-deductible contributions, and (3) $20,000 of earnings. The total amount in the account is $150,000. Per IRC Sec. 408(d), Jon can roll over the zero basis funds ($120,000) into a qualified plan first. This leaves $30,000 in his IRA with a basis of $30,000. Jon may now convert his $30,000 IRA into a ROTH IRA and pay no tax.

When rolling an IRA into a qualified plan, care should be exercised in documenting the transfer. An IRA trustee/custodian is required to report a rollover contribution. If the taxpayer rolled over the distribution into a qualified plan other than an IRA or made the rollover in 2022, Form 1040 instructions direct the taxpayer to include a statement explaining the transaction.

A rollover must be completed by the 60th day from the date a distribution is received. Previously, no exceptions were granted unless the Secretary waived the requirement for circumstances beyond the reasonable control of the participant [IRC Sec. 408(d)(3)(I)]. Use of a distribution as a “60-day” loan almost universally ends up with a denial. The IRS waives the 60-day rollover requirement automatically and without application, if the error was caused by a financial institution, but only if *all the following* apply:

1. The financial institution received the funds before the end of the 60-day rollover period.
2. The taxpayer followed all procedures set by the financial institution for depositing funds into an eligible retirement plan within the 60-day period (including giving instructions to deposit the funds into an eligible retirement plan).
3. The funds were not deposited into an eligible retirement plan within the 60-day rollover period solely because of an error by the financial institution.
4. The funds are deposited into an eligible retirement plan within one year from the beginning of the 60-day rollover period.
5. It would have been a valid rollover if the financial institution had deposited the funds as instructed.

Rev. Proc. 2016-47 now provides a self-certification waiver for failure to meet the 60-day rollover rule. A sample of the certification is included in Rev. Proc. 2016-47.

ROLLOVERS FROM SIMPLE IRAs

A SIMPLE IRA has a two-year period during which a 25% excise tax is applicable for non-qualified distributions. A SIMPLE IRA may be rolled over tax-free only to another SIMPLE IRA account. The two-year period begins on the first day an employee begins to participate in a SIMPLE IRA. A transfer within this period is not a “rollover.” The transfer amount is counted against the annual limit of contributions to an owner’s IRA account.

EXAMPLE: Treatment of rollover from a SIMPLE IRA

Brian, age 45, has $8,000 in his SIMPLE IRA account, with an initial participation date of January 1, Year 1. On July 1, Year 2, he instructs the account trustee to transfer the entire $8,000 to his traditional IRA account. Brian owes income tax on the $8,000 plus a 25% excise tax. He has also exceeded the annual IRA statutory contributory amount of $6,000, so he will owe an excise tax on the excess contributions ($2,000 × 6% = $120) annually until the excess is removed from the IRA.

After expiration of the two-year period, a SIMPLE IRA can be rolled to any type of account, any kind of IRA, 403(b), 457(b), or qualified plan. Inbound transfers from other plans are also allowed after the two-year period.

ROLLOVERS FROM QUALIFIED PLANS

Three elements must exist for a rollover to be tax-free from a qualified plan:

1. The distribution to the participant is an “eligible rollover transaction.”
2. Some or all of the distribution is transferred to an IRA or another qualified plan account.

3. Any property distributed, i.e. anything other than cash must be actually transferred to the receiving account.

If a distribution includes both pre-tax and after-tax funds and the entire amount is not rolled over, the recipient will be considered to have not rolled over the after-tax dollars first.

EXAMPLE: Treatment of rollover from a qualified plan

Laurie has $200,000 in her 401(k) plan account, of which $25,000 is from after-tax contributions. On leaving her employer, she takes a full distribution. She keeps $20,000 to pay off her credit cards and deposits the $180,000 balance into her traditional IRA. The taxable amount of the distribution is zero and her IRA now has a basis of $5,000 that should be reported on Form 8606 in the year the distribution is rolled over.

When a taxpayer is moving from one employer to another, consider rolling amounts in the prior employer's qualified plan to the new employer's plan. However, not all plans accept inbound transfers. Additionally, there are penalty exceptions differences between IRAs and qualified plans.

Depending on the character and nature of the distribution it may be tax prudent for a taxpayer to establish a conduit IRA to receive the funds from a qualified plan distribution.

ROLLOVERS FROM DESIGNATED ROTH IRA ACCOUNTS

Participants in employer Section 401(k) or 403(b) plans may make a designated Roth account (DRA) election. Plans are not required to offer a DRA, but most large employer plans do:

1. Elected deferrals can be placed in a DRA and growth is tax-free like a Roth IRA account.

2. Elected deferrals are made after-tax and do not reduce taxable income.

In-plan Roth conversions are allowed. Once an election is made, deferrals cannot be modified. A participant can make an in-plan conversion from a pre-tax account to a DRA. The funds are taxable at the time of the conversion and no recharacterization is allowed.

WHERE TO GO FOR MORE INFORMATION

- *PPC's Guide to Small Employer Retirement Plans*
- Quickfinder's *IRA and Retirement Plans Handbook*
- IRS resources:
    - Publication 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*
    - Help from the IRS: **www.irs.gov/retirement-plans**
    - IRS Publications 560, 590, and 598, available at **https://apps.irs.gov/app/picklist/list/formsPublications.html**

  - Choosing a Retirement Plan at **www.irs.gov/retirement-plans/help-with-choosing-a-retirement-plan**

- Interactive DOL web tool to assist with ERISA compliance available at **https://webapps.dol.gov/elaws/ebsa/fiduciary/introduction.htm**

- Historical IRA Contribution Limits listed at **https://cashmoneylife.com/traditional-Roth-ira-contribution-limits**

- America's IRA Experts FAQ list available at **www.irahelp.com/faqs.php**

CHAPTER 17: INTEREST, DIVIDENDS, AND OTHER INVESTMENTS

Learning Objectives

Completion of this chapter will enable participants to—

- Determine the taxability and filing requirements for interest, dividends, and other investments.
- Calculate premium and discounts on original issue discount (OID).
- Determine when the below market interest rate rules apply.

BREAKPOINTS FOR IMPOSITION OF CAPITAL GAINS AND QUALIFIED DIVIDEND RATES

The adjusted capital gain of a noncorporate taxpayer is taxed at maximum rates of 0%, 15%, or 20%. The adjusted capital gain is the net capital gain plus any qualified dividend income less long-term gains specified gains that are taxed at the maximum of—

1. 28% for gain on the sale of collectibles.
2. 25% on unrecaptured Section 1250 gain attributable to unrecaptured depreciation on real estate.

The long-term capital gain rate is statutorily set and adjusted for inflation. For tax years beginning after December 31, 2017, and before January 1, 2026, TCJA made the following changes:

1. The 0% rate is applied to adjusted net capital gain that is below the maximum zero rate amount. (Any other individual was referenced as half the married filing joint amount).
2. The 15% is applied to the amount that exceeds the 0% rate and that is below the 15% rate amount.

Maximum Capital Gain and Qualified Dividend Amounts (2021) Maximums (Rev. Proc. 202-45)		
	0%	**15%**
Joint/Surviving Spouse	$80,800	$501,600
Married Filing Separately	$40,400	$250,800
Head of Household	$54,100	$473,750
Single	$40,400	$445,800
Estate & Trust	$2,700	$13,250

INTEREST AND DIVIDENDS—ORDINARY INCOME

Generally, interest and dividends will be treated as ordinary income. Interest and dividends are generally considered net investment income (NII) for the 3.8% net investment income tax (NIIT).

QUALIFYING DIVIDENDS—TAXED AT CAPITAL GAIN RATES

Qualified common and preferred dividends received by an individual shareholder from domestic and certain foreign corporations are taxed at the same rates as adjusted net capital gain [IRC Sec. 1(h)(11)].

To qualify, the taxpayer must have held common stock more than 60 days during the 121-day period that began 60 days before the ex-dividend date. For preferred stock, if the dividends are attributable to a period of more than a year, the taxpayer must have held the stock more than 90 days during the 181-day period that began 90 days before the ex-dividend date.

SERIES E AND EE SAVINGS BONDS

EE Bonds have a maturity of 30 years. All accrued interest will be reportable in the year of maturity even if the bond was not surrendered.

The accrued interest of a bond can be determined by entering the detail of the bond (e.g., series, denomination, serial number, issue date) in a tool available at **www.treasurydirect.gov/indiv/tools/tools_redemptiontables.htm**. (**Note:** As of January 1, 2012, the Treasury discontinued issuing paper EE bonds.)

Taxpayers with bonds that are discovered past their maturity with unreported interest are required by IRC Sec. 454(c) and Reg. §1.454-1(a)(1) to file amended returns for the year in which the bond(s) reached maturity.

Taxpayers most frequently report the unreported accrued interest in the year of discovery for closed years. The IRS has never officially commented on this practice but seems to passively accept it.

OBSERVATION: Treasury Direct indicates that there are billions of bonds that are uncashed and have stopped earning interest. US Treasury Department maintains records on uncashed bonds back to 1974. Assistance for working with paper bonds can be found at **www.treasurydirect.gov/indiv/research/indepth/ebonds/res_e_bonds_eereplace.htm**. Bonds purchased after 1989 *are not* in the database.

Lost, stolen, or destroyed US Savings Bonds (Series EE, I, or HH) can be recovered by filing Form 1048 with the Bureau of the Fiscal Service. If the taxpayer has been a victim in a Federal Disaster Area, there are abbreviated procedures available for recovery of the bond.

BOND PRICING OVERVIEW

Bond pricing is based on numerous factors including the bond's interest rate, term to maturity, and financial condition of the issuer and market expectations concerning interest rates/rate changes. Accordingly, bonds can be sold/issued at par, at a discount or at a premium.

Stated Redemption Price at Maturity (SPRM)

SRPM for OID purposes is the face value of the bond or debt instrument. It includes interest payable at maturity but not interest payable at a fixed rate at periodic intervals of a year or less during the entire term of the debt instrument [IRC Sec. 1273(a)(2)].

Par means the bond was purchased at the SRPM or the principal amount due at maturity. If the purchaser holds the bond until maturity, they will earn the stated rate of return on the bond.

Discount means the bond was issued or purchased below the SRPM. The difference between the SRPM and the purchase price is the discount. Tax law differentiates between the discount on newly issued bonds and bonds purchased in the secondary market:

1. OID is the discount on newly issued bonds. OID is required to be recognized as income over the term of the bond. [IRC Sec(s). 1272 and 1273].

2. Market discount is the discount on bonds that are purchased in the secondary market or not at the original issue [IRC Sec. 1278(a)(2)(A)]. The rules for dealing with the discount differ. See "Market Discount Bonds" later in this chapter.

EXAMPLE: Determining OID Interest

Matt pays $18,000 for an original issue bond that, at maturity, will yield $20,000. The $2,000 difference between the purchase price and the yield is OID interest. On Schedule B, Matt will include the ratable portion of any interest reported to him on Form 1099-OID. This $2,000 OID is ordinary interest income, not capital gain. If Matt holds the bond to maturity, his basis in the bond would increase by $2,000 to $20,000.

Premium means the bond was issued or purchased above the SRPM. A premium can be paid at the original issue or when purchased in the secondary market.

An OID bond sold at maturity will normally be reported with no gain or loss on Form 8949, as the purchase price will be adjusted by the amortization of any premiums paid or discounts received.

An OID bond sold *before* maturity may give rise to a capital gain or loss when the selling price is compared to the basis (aka the adjusted issue price), which is the sum of the purchase price, plus any OID interest accrued through the date of sale, plus premium paid or discount received (if any) that is amortized over the period owned by the taxpayer.

OID accruals on tax-exempt bonds will be treated like any other tax-exempt interest. That interest accrual reported will be added to the basis of the bonds in the same manner as taxable OID.

ORIGINAL ISSUE DISCOUNT (OID)

The IRS maintains a list of publicly traded bonds issued at a discount annually. You can obtain OID tables back to 2005 at **www.irs.gov**. Please note, the information is normally updated by the IRS in late January or early February. Tables from the current year to 2006 can be found at **www.irs.gov/forms-pubs/original-issue-discount-oid-tables**.

Taxpayers who hold debt instruments with OID should receive a Form 1099-OID indicating the amount of OID income for that year. The form will also indicate any periodic interest paid on the security for the tax year. Both the OID and interest payment must be reported.

The OID must be recomputed when—

1. The taxpayer purchases the bond after the original issue date at an acquisition premium or at a cost that exceeds the original issue price increased for prior OID but at less than the total of all remaining payments. In this case, the amount of the OID will be less than what is reported on the 1099-OID, or

2. The debt instrument is a stripped bond as in the case of zero-coupon bonds issued by the Treasury's STRIPS program.

When the OID is recomputed, the amount of the OID shown on the Form 1099-OID should be shown on Schedule B followed by the adjustment identified as "OID adjustment."

For Form 1099-OID, if the debt instrument is a covered security, the broker will calculate the amortization of the acquisition premium. The broker can report the OID in the following manner:

1. With the gross OID amount in box 1 or box 8 and the acquisition premium amortization in box 6, or

2. The net amount of OID that reflects the acquisition premium amortization for the year in box 1 or box 8.

Issuers can also choose to report the periodic interest on Form 1099-INT or Form 1099-OID.

De Minimis **Amount**

The discount can be ignored if is deemed to be less than the *de minimis* amount. The *de minimis* amount is 0.25% of the SRPM multiplied by the number of complete years from the date of the issue to maturity [Reg. §1.1273-1(d)(2)]. When the *de minimis* amount applies, the taxpayer will recognize the income when the principal payments are received.

EXAMPLE: Determining *de minimis* status of bond discount

A bond issued on January 1, 2020 is redeemable on August 15, 2023 for $100,000. It has been three years since the date of issue. The *de minimis* amount is calculated as 0.25% of $100,000 (SRPM) × 3 years, or $750. If the bond is issued below $100,000 but above $99,250, the amount is *de minimis* and the discount will be recognized on receipt of the principal payments.

DISCOUNT/PREMIUM METHODS

Discounts and premiums are normally subject to amortization. There are two methods that a premium or discount can be subject to—

1. Ratable method (the simplest). The discount/premium is earned on a daily basis over the remaining period until stated maturity, or

2. Current yield to maturity Method (sometimes called the "constant interest rate method") slows the recognition of income early on. The discount is earned as if the bond had been issued on the taxpayer's acquisition date and at a constant interest rate over the remaining period to maturity. The effect of this method is to back-load the earnings while avoiding the recognition of income in

the year of maturity or sale. Generally, the bond discount is reported on the ratable method, however the taxpayer can elect to use the “constant interest rate” or “current yield to maturity”.

CAUTION: For a debt instrument acquired on or after January 1, 2015, a broker (for broker reporting purposes) cannot take a customer's election under Reg. §1.1272-3 (constant yield) into account when computing and reporting basis [Reg. §1.6045-1(n)(11)(i)(A)]. This then requires the taxpayer or the practitioner to calculate and maintain the calculation.

EXAMPLE: Determining bond yields

Tom purchases a bond for $700 with 3 years remaining to maturity and a stated redemption price (maturity value) of $1,000. The following table compares the two methods. The ratable yield is derived by dividing the $100 OID by the $700 purchase price, then dividing $100 by $800, and then dividing $100 by $900. The constant yield simply takes the sum of the ratable yield for the three years and divides by 3.

Year	Ratable Method	Constant Interest Rate	Difference	Ratable Yield	Constant Yield
1	$ 100.00	$ 88.40	$ 11.60	14.3%	12.6%
2	100.00	99.50	$ 0.50	12.5%	12.6%
3	100.00	112.10	$ (12.10)	11.1%	12.6%
Total	$ 300.00	$ 300.00			

WARNING: The basis of an OID bond can be difficult to determine. OID is figured differently depending on the type of debt and the date issued. For example, contingent payments create payments that are contingent as to timing and amount. If the actual payment is different than the projected fixed amount, this is a positive or negative adjustment (sometimes called an “OID shortfall”).

A taxpayer who has acquired a debt instrument with acquisition premium is required to reduce the amount of OID includible in income each year by the amount of acquisition premium allocable to the tax year.

ORIGINAL ISSUE DISCOUNT ON TAXABLE BONDS

For government and corporate bonds issued after April 3, 1994 (also may be relied upon for bonds issued after December 21, 1992, and before April 4, 1994), OID is calculated using a constant interest rate method compounded over any period not to exceed one year (i.e., different accrual periods may be used as long as no period extends more than one year, and each scheduled payment of principal and interest occurs at the end of the accrual period) [Reg. §1.1272-1(b)].

Taxpayers can elect to treat all income from a debt instrument, including stated interest, OID, and market discount, as OID (IRC. 1.1272-3). This effectively results in the taxpayer recognizing all income from the debt instrument using the accrual method of accounting. The election has limited application to individuals using the cash method.

Securities Exempt from OID Rules

U.S. savings bonds, short-term obligations with fixed maturity dates of one year or less from date of issue such as short-term CDs and Treasury bills, and loans less than $10,000 between two individuals are exempt from these rules.

For U.S. savings bonds, as an alternative to reporting interest at maturity, cash basis taxpayers can elect to report the interest on the accrual method (i.e., as earned) [IRC Sec. 454(a)]. An election, once made, applies to all U.S. savings bonds owned currently (year of election) and subsequently acquired. In the year of election, the taxpayer reports all income accrued on the bonds from the date of acquisition.

A Section 1282(b)(2) election can be made for short-term obligations to recognized income and the OID as it accrues rather than at maturity. Once the election is made, it applies to *all* short-term obligations acquired by the taxpayer on or after the first day of the first tax year to which the election applies.

OID ON TAX-FREE BONDS

OID on tax-exempt bonds is not subject to tax when it accrues. However, the basis of a tax-exempt bond is increased by the amount of OID that would have been recognized as income if the bond were taxable (reduced by acquisition premium amortization, if any) [IRC Sec. 1288(a)(2)].

For tax-exempt bonds that contain both OID and acquisition premium, the regulations permit a broker to report either a gross amount for both OID and amortized acquisition premium or a net amount of OID that is net of the amortized acquisition premium attributable to the OID [Reg. §1.6049-9(c)].

The annual adjustment to basis for accrued OID depends on the tax-exempt obligation's term:

1. If the term is more than one year, the adjustment is computed under the constant yield method described in IRC Sec. 1272(a).

2. If the term is one year or less, the annual adjustment is computed either under the ratable accrual method or the constant interest method. The bond's basis is increased for OID that would, for taxable bonds, be considered zero because of the *De Minimis* exception.

CAUTION: While the OID on tax-free bonds is not taxable, market discount on a tax-exempt bond is not tax-exempt.

MARKET DISCOUNT BONDS

The market discount rules do not apply to short-term obligations having a fixed maturity date one year or less from issue (T-bills), tax exempt bonds acquired before May 1, 1993 and U.S. savings bonds. These rules also do not apply if the *de minimis* amount applies.

For a covered security acquired on or after January 1, 2015, market discount will be calculated by default, on a ratable accrual basis unless the broker is notified in writing in accordance with Regulations section 1.6045-1(n)(5) that the taxpayer does not want to make a constant yield election for market discount under IRC Sec. 1276(b).

A taxpayer can elect to include the market discount in interest income [IRC Sec. 1278(b)]. The election is made on a timely filed return which includes the following statement:

ELECTION TO INCLUDE ACCRUED BOND MARKET DISCOUNT IN INCOME CURRENTLY PURSUANT TO IRC SEC. 1278(b)

> Taxpayer hereby elects under the automatic consent procedures outlined in Rev. Proc 92-67 to include accrued market discount in gross income. Taxpayer has used (ratable accrual or constant interest rate) method to determine the market discount attributable to the tax year covered by this return.

If no election is made, the discount is not recognized until the bond is disposed, redeemed, or matures, at which time the discount is taxed as ordinary income (interest).

> **OBSERVATION:**. The complexity of the reporting rules and the size of the OID investment should be considered before making elections that require additional complications for the taxpayer. In many cases, accepting the amounts reported on Form 1099-B can be the best course of action.

MARKET PREMIUM BONDS

Premium

The bond was issued or purchased above the SRPM. A premium can also be paid at the original issue or when purchased in the secondary market.

Taxable Bonds

The premium remains part of a taxpayer's basis in the bond until disposed of unless the taxpayer elects to amortize it while the bond is held [IRC Sec. 171(c)]. To make the election, the taxpayer attaches a statement to his return.

Holders of tax-exempt bonds are required to amortize bond premium, although no federal deduction is allowed for the amortization [IRC Sec. 171(a)(2)].

Making the Election

The election is made on a timely filed return for the first year the election is to be effective. The election is made by claiming the amortization on the return and attaching a statement to the return. Attach the following statement to the return:

ELECTION TO AMORTIZE BOND PREMIUM

> Taxpayer hereby elects to amortize bond premium pursuant to IRC Sec. 171(c) and Treasury Regulation 1.171-4(a).

Broker Reporting

Brokers are required to assume that the taxpayer has made the election to amortize bond premiums unless the broker has been notified in writing to the contrary by the taxpayer. The taxpayer must still make an affirmative election to amortize the bond premium on taxable bonds.

PLANNING TIP: An election to amortize bond premium on taxable bonds results in an ordinary income reduction since the amortization is treated as an offset to interest income. If an election is not made, the premium generates a capital loss when the bond is disposed of (via sale or maturity) because it is an addition to the tax basis in the bond. However, the administrative burden of computing and tracking the amortization should be considered.

The amount of bond premium amortization that can offset interest income on Schedule B cannot exceed the amount of interest income the taxpayer reports from that bond for the same accrual period [Reg. §1.171-2(a)(4)].

Any excess premium is deductible under IRC Sec. 171(a)(1) as other itemized deductions not subject to the 2% of AGI floor. The amount deductible on Schedule A is further limited to the total amount of interest income the taxpayer reported on the bond for all prior accrual periods. Any remaining amortization is carried forward to the next accrual period. The TCJA repeal of the 2% miscellaneous itemized deduction does not affect this provision.

However, for a taxable zero-coupon instrument purchased at a premium, an electing taxpayer deducts any remaining premium under IRC Sec. 171(a)(1) when the instrument is sold, retired, or otherwise disposed of rather than taking a capital loss on the transaction [Reg. §1.171-2(a)(4)(i)(C)].

Additional rules apply in calculating the bond premium amortization on (1) variable rate debt instruments, (2) inflation-indexed debt instruments, (3) bonds having alternative payment schedules, and (4) bonds that have remote or incidental contingencies. (See Reg. §1.171-3 for more information.)

Whether taxable or tax-exempt, the taxpayer's basis in a bond is reduced for bond premium amortization [IRC Sec. 1016(a)(5)].

When the new holder of a debt instrument purchases the bond on the secondary market and pays an amount greater than the adjusted issue price (original face plus interest accruals), the purchaser has paid a “premium” for the bond. The premium is amortized on a daily basis over the remaining period until stated maturity [IRC Sec. 1272(a)(7)].

By default, the premium will be amortized using the ratable method. This is determined by dividing the number of months remaining from the date of acquisition by the date of maturity of the premium.

EXAMPLE: Calculating bond amortization

Peter purchases an OID bond for $50,000 when the adjusted issue price is $45,000. Peter has paid a premium of $5,000. There are 1,000 days left until bond maturity; thus, the amortization will be $5 per day, which reduces reported income by $5 per day.

The taxpayer can elect to use the constant yield method, which will “fix” the amortization based on the current adjusted issue price of the bond.

The adjustment is allowed from income and should be made on Schedule B as a reduction in the OID income and titled “OID adjustment.”

EXAMPLE: Determining OID adjustment

Seller's OID Adjustment

Wendy purchased a 10-year, zero coupon, $1 million municipal bond at original issue for $700,000. The yield is 4%. Two years later, she sells the bond to Chip for $770,000, when the accrued OID is $57,120. At the time of the sale, Wendy's basis is $757,120 ($700,000 + $57,120), she therefore recognizes a capital gain of $12,880 ($770,000 – $757,120).

Buyer's OID Adjustment

Chip will amortize the $12,880 premium he paid over the remaining life of the bond. Since there are eight years (2,920 days) remaining until maturity, the premium paid ($12,880) would be divided by the days remaining, which means that Chip would take a deduction on his Schedule B of $4.41 per day ($12,880 ÷ 2,920 days).

If he holds the bond until maturity, he will recognize no gain or loss because his basis will be $1 million, computed as follows:

Purchase Price (what Chip paid for the bond)	$ 770,000
OID during Chip's holding period ($300,000 – $57,120 accrued OID)	242,880
Less premium amortization during holding period	(12,880)
Chip's basis at time of bond sale	$ 1,000,000

BELOW-MARKET INTEREST RATES (IRC SEC. 7872)

If the interest charged for a loan meets or exceeds the applicable federal rate (AFR) when the loan is made, no additional imputed interest income or expense is calculated.

The AFR is published monthly by the IRS in an Internal Revenue Service bulletin, which can be found at **www.irs.gov** and search for "applicable federal rate" for the month in which the loan begins:

1. Short-term is for demand loans and term loans ≤3 years,

2. Mid-term is for term loans > 3 years and ≤ 9 years, and

3. Long-term is for term loans >9 years.

If the loan has no interest or is below the AFR for the loan terms, the amount of deemed interest must be calculated:

1. It is assumed that the lender has transferred to the borrower an amount equal to the "foregone" interest charge for the loan.

    a. For loans between individuals, the foregone interest is considered a gift—subject to the gift tax provisions of IRC Sec. 2503 (the annual exemption amount for 2019 is $15,000).

b. For a loan to a stockholder from a corporation, the foregone interest is a taxable dividend.

c. For a loan to an employee from a corporation (or any entity), the foregone interest is taxable as compensation (along with all payroll tax implications).

2. There is an assumption that the imputed interest equal to the AFR is paid by the borrower to the lender.

NOTE: Lenders reporting imputed interest income, or borrowers claiming an interest deduction, must attach statements to their tax returns indicating the amount of the interest, how it was calculated, plus the names of the parties involved and their taxpayer identification numbers. This allows the IRS to do its "matching."

Specific exceptions to below-market rules include:

1. The $10,000 gift loan exception [IRC Sec. 7872(c)(3)].

2. Employee relocation loans: If due to a transfer, an employee borrows money from an employer to purchase a new principal residence (within the meaning of IRC Sec. 217), the loan is exempt from IRC Sec. 7872.

3. Loans exempted under Temp. Reg. §1.7872-5T(b), such as an arm's length commercial-type transaction (e.g., 0% financing by an auto manufacturer).

4. Loans between individuals are not subject to imputed interest, provided—

   a. The total outstanding loan balance owed by the "borrower" at all times during the year does not exceed $100,000, and

   b. The borrower's NII does not exceed $1,050 [IRC Sec. 7872(d)(E)(ii)]. If the NII limit is exceeded, the imputed-interest rules will apply, but the interest to be imputed is limited to the total of the borrower's investment income from other sources.

EXAMPLE: Determining application of imputed interest rules

In 202X, Morgan loans $90,000 to his son, Chase, to use as a down payment on a yacht. Chase's investment income is $950. Since the loan is below $100,000, no interest income is imputed. However, Chase must provide his father with a signed statement that his investment income for 202X is $1,050 or less.

Variation: Assume the same facts, except that the blended AFR for 202X is 2.50% and that Chase has investment income of $1,500. Since Chase's investment income is more than $1,050, the imputed interest rules apply. The imputed interest on $90,000 at 2.50% is $2,250. The amount of interest income to be reported by Morgan on his Schedule B is limited to the lesser of Chase's actual investment income of $1,500, or the imputed interest of $2,250.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 1212, *Guide to Original Issue Discount (OID) Instruments*
- IRS Pub. 1281, *Backup Withholding for Missing and Incorrect Name/TIN(s)*
- Instructions for Form(s) 1099-INT, 1099-DIV, and 1099-OID

CHAPTER 18: NET INVESTMENT INCOME TAX (NIIT)

Learning Objectives

Completion of this chapter will enable participants to—

- Calculate the 3.8% Net Investment Income Tax (NIIT).
- Apply strategies to reduce the NIIT.

WHAT'S NEW

After much discussion of repeal, the NIIT survived the Tax Cuts and Jobs Act (TCJA) and subsequent legislation.

BACKGROUND

The NIIT was established as IRC Sec. 1411 under the Affordable Care Act, effective for tax years beginning in 2013. A 3.8% net investment income tax (NIIT) is imposed on the net investment income (NII) of individuals, estates, and trusts (IRC Sec. 1411). This surtax is paid in addition to any regular tax and AMT.

NIIT CALCULATION

Under IRC Sec. 1411(a)(1), the NIIT is calculated as 3.8% × the lesser of—

1. MAGI in excess of the thresholds, or
2. Net investment income.

Worksheet:

	AGI	XX
+	Foreign Earned Income Exclusion for US Citizens and Residents Living Abroad	+ XX
=	MAGI	XX
–	Threshold (see definition below)	– XX
=	MAGI in Excess of the Threshold (1)	XX
	Net Investment Income (2)	XX
	Lesser of (1) or (2)	XX
×	Rate	× 3.8%
	Net Investment Income Tax (NIIT)	XX

EXAMPLE: Calculating NIIT

Pop and Tina are married with MAGI of $275,000 and $50,000 NII. They owe NIIT of $950 based on the MAGI in excess of the threshold [($275,000 – $250,000) × 3.8%].

Variation: Same as above, except MAGI is $375,000. They owe NIIT of $1,900 based on the NII {[lesser of $125,000 ($375,000 – $250,000) or $50,000] × 3.8%}.

THRESHOLDS AND APPLICABLE TAXPAYERS

NIIT applies when MAGI exceeds $200,000 for Single or HOH filers; $250,000 for MFJ and Qualifying Widow(er) filers; and $125,000 for MFS filers.

These thresholds are not adjusted for inflation.

The NIIT applies to U.S. citizens and residents. The NIIT *does not* apply to nonresident aliens (NRAs) [IRC Sec. 1411(e)]. There are special rules for dual-resident and dual-status individuals. A dual-status individual who is a resident for part of the year is subject to NIIT for that part of the year (see the instructions to Form 8960 for details). Taxpayers can elect to file jointly with a nonresident spouse by checking the box under IRC Sec. 6013(g) or (h) on Form 8960.

PLANNING TIP: The filing status of any U.S. citizen or resident married to a NRA is MFS for purposes of MAGI and NIIT. By making an election to file jointly, the taxpayer is required to combine both spouses' incomes, gains, losses, and deductions. However, taxpayers can increase the threshold to $250,000 (MFJ threshold). This could potentially be a great NIIT savings if the NRA spouse has low income and low NII and the U.S. taxpayer's NII is over the single threshold.

NET INVESTMENT INCOME [IRC SEC. 1411(c)]

Net Investment Income (NII) is—

1. Gross income from taxable interest (Form 8960, line 1):

    a. Self-charged interest from a partnership or S corporation that is a non-passive activity, which should be reported on line 7, "Other Modifications"

    b. Tax-free interest, like municipal bond interest, which is excluded from line 1.

2. Gross income from ordinary dividends (Form 8960, line 2).

3. Gross income from annuities (nonqualified plans) (Form 8960, line 3).

PLANNING TIP: Annuity amounts subject to NIIT should be identified with the distribution with a "Code D Annuity Payments from nonqualified annuities that may be subject to Tax under section 1411" in Box 7 on Form 1099-R.

4. Gross income from rents and royalties (Form 8960, line 4a). Those for which the IRC 1411 does not apply are reported on Line 4b. Since amounts reported on line 4a can be both net income or

net losses, Line 4b amounts can be both additions and subtractions. Line 4b adjustments are added as positive amounts for negative adjustments and net negative for positive adjustments.

5. Gross income and gains from passive business activities, which means business activities in which the taxpayer does not materially participate (Form 8960, lines 4a and 4b).

CAUTION: All income and gains must still be listed on line 4a, and then reduced for those that are excluded from NIIT on line 4b.

6. Capital gain distributions from mutual funds (Form 8960, line 5a).

7. Gains from selling assets held for investment (includes stocks, bonds, investment real estate and gains on sale of personal residence, if any after the IRC Sec. 121 exclusion) (Form 8960, line 5a).

8. Gains from dispositions of passive ownership interests in partnerships and S corporations (Form 8960, line 5a).

CAUTION: All gains or losses still must be listed on line 5a and then adjusted for those that are excluded from NIIT on line "5b - Net gain or loss from disposition of property that is not subject to net investment income tax" and "5c - Adjustment from disposition of partnership interest or S corporation stock."

9. Controlled Foreign Corporation (CFC) and Passive Foreign Investment Company (PFIC) gains, which are typically reported on Form 8960, lines 1–5; adjustments may be required for an owned interest in a CFC or PFIC (Form 8960, Line 6).

10. Gross income and gains from the business of trading in financial instruments or commodities, regardless of whether the activity is non-passive [Reg. §1.1411-5(c)], (Form 8960, line 7).

OBSERVATION: The amounts of NII included on the taxpayer's Form 1040 by reason of "Form 8814 Parents' Election to Report Child's Interest and Dividends" are included when calculating the taxpayer's NII.

ALLOCABLE DEDUCTIONS FOR NII [REG. §1.1411-4(F)]

Following are allocable deductions allowed when determining NII:

1. *Investment interest expense*, as defined in IRC Sec. 163(d)(1), to the extent allowed for regular tax purposes. The excess is carried over to future years for regular and NIIT purposes (Form 8960, line 9a).

2. *State and local taxes* (SALT) as defined in IRC Sec. 164(a)(3). Any "reasonable" method can be used to calculate the portion of tax attributable to NII. For example, an allocation based on the ratio of NIIT gross investment income and net gain, divided by total gross income, multiplied by all or part of state and local taxes deducted would be a reasonable method (Form 8960, line 9b). This allocation is made after the application of the SALT limitation.

3. *Investment expenses*, as defined by IRC Sec. 163(d)(4)(C) (Form 8960, line 9c). These expenses are suspended from 2018-2025 [IRC Sec. 67(g)].

4. Deductions allocable to gross income from rental and royalty, passive business activities and the business of trading in financial instruments or commodities (reflected on Form 8960, lines 4 and 5).

5. Penalties on early withdrawal of savings (Form 8960, line 10).

6. Foreign taxes paid (not a foreign tax credit)- unfortunately, foreign taxes are included in SALT limitation.

7. Section 1411 Net Operating Loss (NOL) amount allowed under IRC Sec. 172 [Reg. §1.1411-4(h)]. The adjustment is limited to the proportion of the NOL that is attributable to NII.

8. The deduction allowed to an annuitant for the annuitant's last tax year under IRC Sec. 72(b)(3).

9. Itemized deductions for federal estate and generation-skipping transfer taxes allowed under IRC Sec. 691(c) to the extent allocable to investment income.

10. Deductions allowed under IRC Sec. 171(a)(1) for amortizable taxable bond premiums.

CAUTION: Deductions from NII were allowable to the extent that a deduction was not limited by either IRC Sec. 68's Pease limitation on itemized deductions or IRC Sec. 67's 2% of AGI limitation on Miscellaneous Deductions.

The TCJA suspends miscellaneous itemized deductions subject to the 2%-of-AGI floor for any tax year beginning after 2017, and before 2026. [IRC Sec. 67(g)]. The miscellaneous itemized deductions to which the 2%-of-AGI floor applied included the (not exhaustive) investment expenses and expenses for the production or collection of income, and tax determination expenses (e.g., preparation fees). These deductions are not only suspended for regular tax purposes, they are suspended for NIIT purposes also.

In addition, the TCJA suspends the overall (Pease) limitation on itemized deductions for tax years 2018–2025.

While the TCJA limits state and local tax (SALT) deductions to $10,000 for years 2018–2025, the SALT limit is under IRC Sec. 164(b)(6). Unfortunately, the SALT limitation is taken into account before the allocation of state and local taxes to NII. Foregoing the deduction of real estate taxes allows the entire $10,000 SALT limit to be applied to state and local taxes, and thereby increasing the SALT deduction for NIIT. This normally ends up with a relatively minor reduction in the tax.

11. Expenses incurred in the determination, collection, or refund of any tax under IRC Sec. 212(3) and Reg. §1.212-1(l) to the extent allocable to investment income. This would include tax preparation fees (see item 10 CAUTION alert).

12. Fiduciary expenses for estates and trusts under Reg. §1.212-1(i) to the extent allocable to investment income (see item 10 CAUTION alert).

Tax credits may be used to offset NIIT liability. However, credits are only allowed against Chapter 1 (regular income tax) of the IRC and cannot reduce NIIT. Most notable are foreign tax credits and general business credits.

INCOME EXEMPTED FROM NII (REG. §§1.1411-4, -5, -8, AND -9)

The following income is exempted from NII:

1. All wages and self-employment income, except the business of trading in financial instruments or commodities.

2. Operating income from non-passive business activities in which material participation can be shown.

3. Distributions from a plan or an IRA, including IRC Sec(s). 401(a), 403(a), 403(b), 408, 408A, and 457(b). The exemption also covers deemed distributions, such as a traditional IRA being converted to a Roth IRA, or a loan not being repaid on a qualified plan loan.

EXAMPLE: Retirement income exemption from NII calculation

Candy is unmarried with MAGI of $220,000 (including a $140,000 IRA distribution, a $30,000 Roth conversion, and $50,000 in interest income). Neither the IRA distribution nor the Roth conversion is considered NII. However, the IRA distribution and Roth conversion are included in AGI and will cause her to exceed the threshold. She owes NIIT of $760 based on MAGI in excess of the threshold [($220,000 – $200,000) × 3.8%].

4. Tax exclusions, such as tax-exempt interest income and the principal residence gain exclusion.

5. Tax deferrals, such as a like-kind exchange or installment sales, will be deferred until the year recognized for income tax purposes.

6. Other items, such as social security benefits, alimony received, unemployment compensation, and the Alaska Permanent Dividend Fund.

7. Pass-through income, gains, and losses if the shareholder or partner materially participates in the business.

NET GAINS AND LOSSES FOR NIIT PURPOSES

NII includes net gain (netting gains and losses) to the extent it is taken into account for taxable income for regular tax purposes from all applicable property dispositions [Reg. §1.1411-4(a)(iii)]. Net gain from property dispositions is reduced, but not below zero, by losses that are deductible under IRC Sec. 165, such as casualty, theft, and abandonment losses [Reg. §1.1411-4(d)(3)(i)].

Gain from the disposition of business property that is considered held in the ordinary course of a material participation trade or business (except for the business of trading in financial instruments or commodities) is exempt from NIIT and is defined the same as for IRC Sec. 162 purposes [IRC Sec. 1411(c)(1)(A)(iii)].

Gains from the investment in a business working capital (whether the business is passive or not) are included in net gain for NIIT purposes (Reg. §1.1411-6).

Net capital loss deductions up to $3,000 are permitted to offset certain ordinary income, such as IRC Sec. 1250 depreciation recapture or IRC Sec. 751 “hot assets” [Reg. §1.1411-4(d)(2)].

Net capital loss deductions and IRC Sec. 165 losses allowed for regular tax purposes, but limited to net gain, can be deducted against other types of investment income such as interest, dividends, rental income, and passive business activities [Reg. §1.1411-4(f)(4)(i)].

Excess capital losses carried forward to the following year can offset capital gains in the following year for regular and NIIT purposes. This includes capital loss carryovers from years prior to the application of NIIT (i.e., before 2013).

Reg. §1.1411-4(d)(4)(iii) provides guidance when all or part of capital loss carryover was excluded from NII in the year incurred because it relates to the disposition of non-passive trade or business property. Capital losses are reduced by the lesser of:

1. The capital losses carried over to that year for regular purposes, or

2. The amount of net capital loss excluded from NII in the preceding year because it relates to the disposition of non-passive trade or business property.

BUSINESS, PASSIVE, AND RENTAL ACTIVITIES

Generally, income, less related deductions from the ordinary course of a non-passive trade or business, and gains or losses from property held in the ordinary course of a trade or business as defined in IRC Sec. 162 are not included for NIIT purposes (except for the business of trading in financial instruments or commodities). [IRC Sec. 1411(c)(1)(A)(iii) and Reg. §1.1411-4(b) and (d)(4)]

Income and gains from the investment of business working capital is included for NIIT purposes, regardless of whether the activity is passive or non-passive.

The determination of whether income, gain, and related deductions are from a non-passive activity is made at the owner level.

The determination of whether an S corporation or partnership is engaged in a Section 162 business activity is determined at the entity level.

EXAMPLE: Determining NII inclusivity of business income

Bit owns 10% of O’Honey Bank, an S corporation engaged in the banking business. Bit receives $100,000 ordinary income on a K-1. She materially participates in the business. The $100,000 is not subject to NIIT.

A passive business activity for NIIT purposes is any Section 162 business activity in which the taxpayer does not materially participate. The definition of a trade or business is more restrictive for NIIT purposes than regular tax passive activity rules under IRC Sec. 469.

IRC Sec 1411 also provides exceptions from the NIIT for real estate professionals, self-rentals and self-charged interest. (See Chapter 34 for more detailed analysis.)

PASS-THROUGH ENTITY SPECIAL RULES

Guaranteed payments for services are not subject to NIIT. However, guaranteed payments for the use of capital are subject to NIIT [Prop. Reg. §1.1411-4(g)(10)].

IRC Sec. 736(a) payments are payments for past services, use of capital, unrealized receivables, and partnership goodwill not called for by the partnership agreement. If these payments are subject to self-employment (SE) tax, they are not subject to NIIT. However, IRC Sec. 736(a) payments for the use of capital or the distributive share of partnership income (unless the interest is non-passive) are subject to NIIT.

Generally, any gains from the sale of an S corporation or partnership interest (to the extent that the shareholder or partners are passive owners) are considered held for investment and subject to NIIT.

The disposition of S corporation or partnership interests held all or in part in a non-passive business activity have special rules to calculate the portion subject to NIIT. (See Chapter 34, Passive and Rental Activities, for details regarding the calculation.)

C CORPORATIONS

Generally, any gains from the sale of C corporation stock are considered held for investment and subject to NIIT. Gain from the sale of personal goodwill would be considered income from personal services activities and would not be considered subject to NIIT. Gains excluded under IRC 1202 are excluded from the calculation.

WHERE TO GO FOR MORE INFORMATION

- IRS Form 8960 and Instructions
- IRS Topic No. 559, Net Investment Income Tax
- FAQs at **www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax**

APPENDIX 18A: INCOME CLASSIFICATION FOR CALCULATING NIIT

	Subject to NIIT	Coding Required
Subject to NIIT		
Interest	Y	
Dividends	Y	
Royalties	Y	
Nonqualified Annuity	Y	
Capital Gain	Y	
Sale of Residence—in excess of the exclusion	Y	
Sale of Nonbusiness Property	Y	
Kiddie Passive Income	Y	
Trust that Do Not Distribute Income	Y	Y
Subject to NIIT and Coding Required		
Rents Except for Self-Rental	Y	Y
K-1 Rental Real Estate with Material Participation	Y	Y
K-1 Passive	Y	Y
Gain on Sale of Passive Activity	Y	Y
Business of Trading Financial Commodities—subject to the tax	Y	
Not Subject to the NIIT		
W-2 Income	N	
Retirement Distributions	N	
Unemployment	N	
Social Security	N	
Alimony Received	N	
Alaska Permanent Dividend	N	

	Subject to NIIT	Coding Required
Exclusion Items	N	
Deferral Items	N	
Grantor Trusts	N	
Not Subject to NIIT		
Schedule C with material participation	N	Y
Schedule F with material participation	N	Y
Self-Rental	N	Y
K-1 Business income with material participation	N	Y
K-1 Real Estate Professional	N	Y
Expense offset against Investment Income		
Capital Losses up to $3,000	Y	
Investment Interest	Y	
Investment Expenses—Currently suspended	S	
Management Fees—Currently suspended	S	
Tax Preparation Fees—Currently suspended	S	
Early Withdraw Penalties	Y	
State and Local Taxes—Reduced by SALT limitation	Y	

APPENDIX 18B: PLANNING CHECKLIST

Planning Strategy	✓
1. Reduce MAGI. Generally, the best method to do this is by contribution to qualified plans or IRAs.	
2. Invest in tax-exempt muni bonds. Possible triple benefit with federal, state, and NIIT tax-free.	
3. Use tax-deferred nonqualified annuities to bypass the high-income years.	
4. Nonqualified deferred compensation may also accomplish the bypass of high-income years.	
5. Deferring gains through installment sales and like-kind exchanges will also defer the NIIT.	
6. Look for alternative investments. Real estate often has no profit due to depreciation. Oil and gas activities often have no profit due to depletion and intangible drilling cost write-off.	
7. Time sales of securities and dividends to fit income level for the year.	
8. Life insurance products provide tax-free death benefits and certain contracts can be structured to withdrawal basis first.	
9. IRA and retirement distributions are not subject to NIIT but *can* increase MAGI and exceed thresholds. Consider Roth distributions that *are not* subject to regular or NIIT as an alternative. Note that Roth conversions *do count* toward MAGI.	

CHAPTER 19: IDENTITY THEFT AND REFUND FRAUD

Learning Objectives

Completion of this chapter will enable participants to—

- Recognize the threats that apply to practitioners.
- Describe how to respond to identity theft or tax refund fraud.
- Identify resources available to assist victims of identity theft.

WHAT IS NEW?

- Fraud reports by tax professionals.
- The IRS warns that practitioner threats have increased greatly since the beginning of the pandemic.
- IP PINs are available to all and the IRS encourages adoption.

WHAT IS IDENTITY THEFT?

Individual *Identity theft* and specifically *tax-related identity theft* from the IRS perspective has decreased as a result of increased enforcement efforts and private sector partnerships. The IRS and the Security Summit report that since 2015, tax identity theft has decreased.

Identity theft targets include:

- Social security numbers
- Dates of birth.
- Confidential data contained in computer systems.
- Tax identity theft is more specific. The thief is after information that facilitates—
- Obtaining a tax refund,
- Creating false tax documents, or
- Obtaining employment with falsified identifying information.

THE SECURITY SUMMIT

The Security Summit partnership (**www.irs.gov/pub/irs-utl/about_the_security_summit.pdf**) was formed in 2017 with many of the groups that are part of the filing process. This IRS partnership's current members include—

1. Tax preparation, payroll, and financial product processors (24),

2. State tax administrators (42), and

3. Endorsing industry organizations (8).

As part of this team effort, the Summit partners established the Identity Theft Tax Refund Fraud Information Sharing and Analysis Center (IDTTRF-ISAC) to detect and prevent identity theft tax refund fraud. There are now 65 groups participating in the ISAC which can react and respond quickly as scams arise. The Security Summit group will conduct awareness campaigns and communicate identified issues via the IRS.

Each campaign of the Security Summit team will be as reflective of the current theft environment as possible. The overriding concern by the group for 2020 is the number of tax practitioners who are working from home. The team stated for the upcoming season—

> As of 2021, all tax software providers were required to offer Multi-Factor Authentication options on their products that meet higher standards. Many already do so. A multi-factor or two-factor authentication offers an extra layer of protection for the username and password used by the tax professional. It often involves a security code sent via text.
>
> Most offices have considered the security profile of their IT environment but in the rush to move people home has created large gaps in the security envelope of the firm. The Security Six as recommended by the Security Summit should be reviewed by practitioners in whatever location they are currently operating from.
>
> 1. Anti-Virus Software. Scan the computer regularly
> 2. Firewalls. Hardware and Software
> 3. Two-Factor Authentication. The password got hacked but not of much use without the text device.
> 4. Backup Software/Services.
> 5. Drive Encryption.
> 6. Virtual Private Network (VPN). A secure encrypted tunnel to transmit data from Point A to Point B.

All this activity is being monitored and reported by the Security Summit team to help make the tax administration system safer.

IRS AND THE SECURITY SUMMIT WARN OF INCREASED PRACTITIONER THREATS

Currently, the IRS and the Security Summit are most concerned with the security of tax professionals' computer systems and the theft of business tax identities. Business tax identity information thefts are currently rising at an annual rate estimated to be greater than10%.

Attacks on practitioners, though they are increasing, normally exhibit two primary traits:

1. The scammers have gathered enough data on the firm to make the communication appear to have come from a trusted source, such as—

   a. A College

   b. Bank

   c. Credit Card Company

   d. Cloud Storage Provider

   e. Tax Software Provider

   f. Internal Revenue Service

2. There is a story attached, usually laced with a sense of urgency, to trick the receiver in opening a link or an attachment (so-called “phishing” tactics).

Many of these phishing attempts can be labeled “spear phishing,” which is the most popular attack on tax professionals. While most phishing emails are easily identified because they are scattered in their nature, in a spear phishing email attack, the scammer has taken the work necessary to craft an enticing email, known as a *lure*, which has specific information recognized by the recipient. There are some sophisticated campaigns used by the scammers, such as—

- Posing as a Potential Client - Criminals posed as potential clients, exchanging several emails with tax professionals before following up with an attachment that they claimed was their tax information.

- IRS indicating there is a problem with the firms or a client’s tax account

- A financial services provider asking for a verification of information

Once the message is opened most of the spear phishing emails download either a remote access trojan (RAT) or a ransomware attack onto the system.

- A RAT attack systematically takes over the tax professional’s computer, harvesting the information contained on the file system. Often, the thieves will seize partially completed returns, use the existing data to complete a refund request return, and file them after they have changed the bank account information. In many of these fraudulent returns, the thief has used the practitioner’s tax software to make the request.

- The traditional ransomware attacks will lock the practitioner’s system by encrypting the drive, making the data inaccessible without the correct password, which the thief will gladly sell to the victim once a ransom is paid in cryptocurrency funds.

Boost Security Immunity: Fighting Against Identity Theft

The IRS and the Security Summit group are imploring practitioners to deploy Multifactor Authentication (MFA) or Dual Factor Authentication (2FA) on all applications when possible. Even though almost everybody dislikes MFA or 2FA because it requires performing two electronic verification steps to log in to a system, it has become the gold standard for protecting systems from unauthorized access. While the fraudster may have compromised a user's password, it is much more unlikely that they have the biometric or mobile device to complete the second step.

The second step in MFA and/or 2FA is performed using a variety of means, such as—

- A device the user has in their possession, such as a security token, bank card, key, etc., or
- Information only the user knows, such as PIN, or
- A biometric attribute of the user, such as fingerprint, iris/retina, voice, typing speed, etc., or
- The user's physical location verified via a connection to a private network, GPS ping, etc.

IRS WEBSITE TO HELP PREVENT TAX-RELATED IDENTITY THEFT

In February 2020, the IRS premiered a new page on its website: Identity Theft Central (**www.irs.gov/identity-theft-central**). The resource provides information on preventing ID theft for individuals, tax professionals, and businesses.

There are two resources of particular importance to the practitioner at **www.irs.gov/identity-theft-fraud-scams/identity-theft-information-for-tax-professionals**:

1. *A link to a list of local stakeholder liaisons.* This information is of particular importance to practitioners as they are required to notify the IRS if their office is subjected to taxpayer theft.
2. *An email address for the Federation of Tax Administrators.* This organization can serve as a reporting resource to the different state attorney generals, most who require some level of reporting by tax professionals in the event of a data breach.

The site also features videos on several topics, including a video message from IRS Commissioner Chuck Rettig on the warning signs of phishing email scams (a common tactic used for identity theft), and steps to protect computers and other electronic devices.

THE BIGGEST THREAT: ATTACKS ON THE PRACTITIONER

Practitioners have reported 222 data thefts through June 2021. Following in the footsteps of successful work protecting individual taxpayers, the Security Summit partners have enacted similar protections for business tax returns given that business identity theft is a relatively new area of fraud.

Identity thieves use several different tactics with businesses. They may file a fraudulent tax return, a fraudulent quarterly tax payment, or use stolen Employer Identification Numbers (EINs) to create fraudulent Forms W-2. Thieves also may impersonate business executives to convince payroll or finance employees to disclose employee W-2 information or make wire transfers. Partnerships, trusts, and estates also can be at risk for tax-related identity theft.

According to the Security Summit, firms that survive these attacks and stay in business have a common element of response:

1. They contact each client who is a direct victim and work through the steps of identity theft, as discussed later in this chapter.

2. Assist with the placement of a fraud alert (credit freeze) for clients with the credit reporting agencies. This will stop virtually all activity.

3. Maintain documents for access by the client of any future breach the client might incur.

4. Many firms offer credit monitoring; however, many experts question the value of credit monitoring. The firm's resources can be more effective, and have better results assisting with a credit freeze.

The Security Summit recommend that all tax professionals use the following six basic safeguards for computers and emails:

1. *Antivirus Software* – Once users have installed an anti-virus package; they should scan their entire computer periodically.

2. *Firewalls* – Firewalls can be configured to block data from certain locations or applications while allowing relevant and necessary data through.

3. *Two-Factor Authentication* – Tax professionals should always use this option to prevent their accounts from being taken over by cybercriminals and putting their clients and colleagues at risk.

4. *Backup Software/Services* – Critical files on computers should routinely be backed up to external sources. Tax professionals should ensure that taxpayer data that is backed up also is encrypted.

5. *Drive Encryption* – Given the sensitive client data maintained on tax practitioners' computers, users should consider drive encryption software for full-disk encryption.

6. *Data Security Plan* – All professional tax return preparers must have a written data security plan as required by the Federal Trade Commission and its Safeguards Rule.

IRS Security Experts' Recommendations

Security experts at the IRS also recommend taking the following actions:

- Perform a risk assessment at least annually, but biannually is considered best practice.

- Consult an outside IT expert to assess the risks faced by the firm. The IRS recommends a Certified Information System Auditor (CISA).

- Properly train firm members, as most systems failures are caused by the following human errors:

    - Opening an infected email,

    - Failure to keep anti-malware/spyware software current or to regularly run cleaning programs to scrub infections from the system.

- Having at least one person in the firm trained in cyber security. Training can be obtained in multiple ways, but the AICPA course, Cyber Hygiene for Your Organization or Client, is excellent (**https://future.aicpa.org/cpe-learning/webcast/cyber-hygiene-for-your-organization-or-client**).

Under the Gramm-Leach-Bliley Act (GLB), federal law requires all financial professionals to adopt and implement a written information security plan. The regulatory requirements are embodied in what is often referred to as the "FTC Safeguards" rules:

1. Rev. Proc. 2007-40 sets out the rules which require all e-File providers to have a security plan. (Failure to have a security plan in place risks e-File authorization.)

2. Failure to have an FTC Safeguards security plan can also subject the firm to an FTC investigation.

3. An information security plan may have several components, but must include the following provisions:

    a. Designation of a coordinator

    b. Identification and assessment of risks of client data

    c. An implementation and monitoring program

4. Obtain the proper type of insurance coverage.

CAUTION: Many firms have popped up in the marketplace labeling themselves as "IT insurance experts." Coverage for data breaches can be obtained in most cases as a component of the firm's business owner's policy (BOP); regardless, care should be exercised when purchasing this type of coverage. The following articles are helpful resources about this type of coverage:

1. "What CPAs (Tax Professionals) Need to Know about Cyber Insurance" (**www.cpajournal.com/2017/03/20/cpas-need-know-cyber-insurance**)

2. "Cyber Insurance Can Be Vital Tool as Data Breaches Increase" (**www.cpapracticeadvisor.com/news/12279523/cyber-insurance-can-be-vital-tool-as-data-breaches-increase**)

The IRS also encourages that all practitioners become familiar with Publication 3112, *IRS e-File Application and Participation*.

According to IRS data, the average security breach per incident numbers between 4,000 and 5,000. For practitioners, a breakdown of that number includes not only the client but all the taxpayers on the return (i.e., parents, dependents, payroll, and Form 1099 information). Another consideration is former clients of the firm. One of the surprising discussions at the Security Summit was the comparison of data and how well the thieves were able to mine the database of the practitioner.

Moving work from the office to employees' homes has made the data breach conversation more difficult. Some of the most disturbing issues of data breaches include—

- When work moved home, the number of data breaches increased.

- Most data breaches involved stolen credentials.
- In 2021, it took an average of 287 days to detect and contain a data breach.

ATTACKS HAVE BECOME MORE SOPHISTICATED

Fraudsters have shifted their focus from large-scale hacks to more focused attacks, with businesses their primary target of interest. In raw numbers, 2020 data breaches decreased by 19% over 2019 according to the Identity Theft Resource Center. Judging from the headlines concerning recent high-profile cases such as the Colonial Pipeline attack, ransomware has become the frequent result of database breaches.

For public accounting firms, the proliferation of Bring Your Own Device (BYOB) behaviors has made the issue even more difficult. Rather than being viewed as business devices, these handheld devices are seen as personal assistants with only passing thoughts given to security profiles. If the staff is using their personal devices for business, ensure that a robust cybersecurity policy is in place. Work with the staff to employ such strategies as—

- Mobile device location services:
    1. Find My Device for Android devices (**www.android.com/find**) or
    2. Find My iPhone for Apple devices (**www.icloud.com/find**)
- Using VPN for any remote office work
- Becoming familiar with resources for preventing ransomware attacks, such as those which can be found at **www.nomoreransom.org**
- Installing a password manager, such as Dashlane, Keeper, LastPass, or Enpass.
- What to do if login credentials have been compromised:
    1. Immediately change the password
    2. Visit **www.haveibeenpwned.com** to see what passwords may have been involved in any data breaches.

According to Better Buys (**www.betterbuys.com/estimating-password-cracking-times**) the ability and average speed at which a password can be cracked varies greatly by its character size:

- 7-character password: 0.29 milliseconds
- 8-character password: 5 hours
- 9-character password: 5 days
- 10-character password: 4 months
- 11-character password: 10 years
- 12-character password: 200 years

A few other facts regarding passwords:

- Combining Alpha and Numeric – Extends the timeframe to a Decade
- Combining Alpha, Numeric, and Characters – Extends the timeframe to Multiple Decades
- Passwords will weaken over time regardless—change them periodically!

PRACTITIONER DEFENSE FROM BREACH BY MONITORING EFIN ACCOUNTS

In Tax Tip 2020-31, the IRS encouraged tax practitioners to monitor their e-File accounts. By monitoring the number of returns filed using their EFIN, a practitioner can easily identify if there has been fraudulent use of the credentials in this manner.

The practitioner's EFIN account can be monitored by accessing their e-Services account and taking the following steps:

1. Select their name
2. In the left banner, select *Application*
3. Next, in the left-most banner, select *e-File Application*
4. Select their name again
5. Select *EFIN status*

After the fifth step, the screen will display the number of returns the IRS has identified as filed by the practitioner's EFIN. The IRS updates this number weekly. If the number of returns filed under a practitioner's EFIN has a significant discrepancy, the practitioner should contact the IRS's E-help Desk for Tax Professionals at 866-255-0654. Anytime the practitioner is concerned or has identified a problem with their e-File account, their first phone call should be to the e-help desk.

ANSWERING THE LEGAL RESPONSIBILITY OF A BREACH

There are two questions that must be answered in determining the response by the practitioner of a breach:

1. What is the legal responsibility to the client?
2. What jurisdiction does the court have regarding the breach?

To address the question of legal responsibility, one must look to the state statute that applies to the breach. Each state has differing rules which can be difficult to understand and apply. A state-by-state map can be found at **www.dwt.com/gcp/state-data-breach-statutes**.

Some of the most chilling responsibilities come from the FTC Safeguard rules. The FTC document, *Data Breach Response: A Guide for Business*, is available at **www.ftc.gov/tips-advice/business-center/guidance/data-breach-response-guide-business**.

The IRS reflects many of the same rules with some additional twists of notifying the FBI and Secret Service. Publication 4557, Safeguarding Taxpayer Data, is the primary source of IRS guidance on the practitioner's response. Many of the IRS resources can be found at **www.irs.gov/individuals/data-theft-information-for-tax-professionals**.

Buried deep in the Gramm-Leach-Bliley Act is the simplistic statement that the financial professional is responsible for all client financial losses.

All financial professionals continue to search for the answer to the financial responsibility question. The best answer is to have appropriate insurance. The averages tell the story: a theft of 5,000 records has an average cost of $800,000 to fix. Financial professionals who ignore the problem are likely to find themselves as defendants in lawsuits.

RESPONSE BY THE PRACTITIONER UPON A BREACH

Many of the steps the IRS requires practitioners to take upon a breach can be found in Publication 4557, on pages 11 and 12 in particular:

1. *The first step in the process is to contact the IRS stakeholder liaison.* This individual will assist with the IRS response, and notifying the appropriate IRS representative(s). They will also coordinate future IRS communication regarding the breach. (See the beginning of this chapter for information on contacting the stakeholder liaison.)

2. *Report the theft to the local police.* Even after several years of these types of thefts, the local police departments often think these are not crimes under their jurisdiction. However, filing a police report is also a key step when dealing with credit reporting agencies. The practitioner should be insistent, as having a police report on file is an important part of the process.

3. *Cancel the EFIN immediately.* The stakeholder liaison will assist with this process.

4. *Practitioners should review their PTIN accounts.* The IRS indicates if misuse of a PTIN is suspected, practitioners should report the problem using Form 14157.

    a. PTIN accounts can be accessed by logging into the PTIN website at **https://rpr.irs.gov/datamart/mainMenuUSIRS.do**. Practitioners should review the number of returns the IRS has record of being filed using their PTIN for the current tax filing year.

    b. If the PTIN has been compromised or used fraudulently, the practitioner should discuss PTIN replacement with an IRS representative.

> **CAUTION:** The IRS currently has no formal processes for the cancellation and issuance of a new PTIN. If this occurs, it will be completely at their discretion.

5. *Contact a security expert.* Once a tax preparer has contacted the government, the preparer should contact a security expert to determine the cause and scope of the breach, stop the breach, and prevent future breaches.

    a. The IRS will generally ask the practitioner to provide it with a complete list of all individuals in his or her database, not just those who are known to have been compromised.

OBSERVATION: When the IRS is notified of a practitioner breach, failure to comply with a database release is considered a violation of the practitioner's e-File agreement. In several recent cases, some practitioners attempted to limit the information furnished to the IRS, only releasing confirmed taxpayers that were breached. In this case, the IRS will reply with a demand for all the practitioner's database—and they almost always get what they want.

6. *Get in touch with the firm's insurance carrier.* The IRS has indicated anecdotally that most tax practitioner firms it has worked with on breaches did not have a cyber-insurance policy.

7. *Notify the attorney general in every state where clients filed a return.* This is a daunting task, as not all states have the same notification requirements. Many practitioners insist they only practice in a single state (usually the states in which their respective offices are located). In some jurisdictions, that will be correct. However, in others all it takes is preparing a tax return or financial document for one resident taxpayer of that state.

8. *Send a letter to all clients, not just those the firm is aware have been compromised.* The best way to solve the problem is to get ahead of it by transparency. This is where retaining legal counsel versed in breach response can be worth the investment.

9. *Act as a resource to the individuals who have been affected by the breach.* It is important to remember that while the firm's world has been devastated, the client has been also deeply affected.

RESPONSE BY THE IRS

Previously, the IRS usually would send in a criminal investigation representative to the firm, but this seldom happens anymore due to a lack of resources. Based on author interviews with the IRS, this only occurs about 10% of the time.

All the clients that were reported by the firm will be subject to higher levels of IRS filing scrutiny when returns using their identification numbers are filed, with particular attention paid to—

1. Changes of address.

2. Significant changes to amounts of refunds.

The IRS is likely to send Letter 5747C when a return is filed with these changes. The IRS will frequently ask the taxpayer to validate their identity. A taxpayer is informed by Letter 5747C as follows:

> We need more information to verify your identity in order to process your tax return accurately. Unfortunately, we can't verify your identity online or by phone. You must visit a Taxpayer Assistance Center (TAC).

The taxpayer is instructed to call 844-545-5640 within 30 days if they have recently filed a return. They are requested to bring in certain information to validate their identity. It is possible for the taxpayer to receive LTR 5747C even though they never filed a return. In this case, the IRS is asking for a phone call to 800-830-5084 to inform them of that fact.

The IRS determines to whom it sends LTR 5747C from the list of individuals provided by breached firms. Many practitioners resist sending a complete list to the IRS in an ill-advised desire to reduce inconvenience for their clients.

OBSERVATION: LTR 5747C commands a physical presence in an IRS Taxpayer Assistance Center (TAC), which may be excessively burdensome. When a taxpayer can prove that a physical appearance is an "undue hardship" the IRS will acquiesce and allow the taxpayer to mail the documents.

STEPS FOR VICTIMS

1. *Gather information and lock all computer systems down.* Frequently, the rush to resolve the matter needs to be slowed down to determine exactly what has happened.

2. *Understand the prudent steps to be taken.* There are several websites that provide excellent information, such as privacyrights.org, identitytheft.gov, and ITRC Fact Sheet 100 at idtheftcenter.org, which provides steps in a chronological order to assist in resolving the matter.

3. *Maintain detailed records.* It is critical that accurate records are kept for each step/contact made by the breached individual.

4. *Contact local law enforcement.* This could be difficult because, even with the stigma of tax identity theft today, many local law enforcement officials continue to believe that tax identity theft is not their problem.

5. *File an FTC complaint.* The FTC's website at identitytheft.gov not only lists the steps the injured party should take, but also has a link to file an identity theft report with the FTC. The FTC Identity Theft hotline at 877-438-4338 may also be used.

6. *Contact credit reporting agencies.* A request to place a credit freeze or fraud alert on the individual's account can be submitted online or by phone to any of the three major credit reporting agencies. The agencies' contact information follows:
   a. Equifax
      - 888-298-0045
      - **www.equifax.com/personal/credit-report-services/credit-freeze/**
   b. Experian
      - 888-397-3742
      - **www.experian.com/freeze/center.html**
   c. TransUnion
      - 888-909-8872
      - **www.transunion.com/credit-freeze/place-credit-freeze**

7. *Close any financial accounts that were opened without permission.* This information may be obtained by pulling a credit report.

8. *Place a credit freeze (aka, security freeze) on the credit report account.* Each nationwide credit bureau will need to be contacted to affect a total credit freeze. Extensive background information

is available from the FTC at **www.consumer.ftc.gov/articles/0497-credit-freeze-faqs**. This is a free tool that allows an individual to—

a. Restrict access to his or her credit report, which in turn makes it more difficult for identity thieves to open new accounts in his or her name.

b. Obtain a PIN, which will allow access to the account to remove the “freeze” for a period.

9. *Opting out of unsolicited offers.* Visiting **www.optoutprescreen.com** or calling 888-5OPT-OUT (888-567-8688) allows individuals to request that credit reporting agencies stop providing information for pre-approved credit or insurance offers.

10. *Change all passwords and consider using a password generator/password vault.* (See earlier discussion on password vaults)

PROCEDURES FOR NONIDENTITY THEFT REFUND CASES

Each year, the IRS traps millions of returns with its Return Integrity Verification Operations (RIVO). The intent is to trap refund error or fraudulent returns.

An example of one of the hold programs is the Pre-Refund Wage Verification Hold, an attempt to identity taxpayers who have claimed incorrect withholding amounts whether by error or intentionally. The service will attempt to verify the taxpayer’s withholding by a review of payor filed W-2s and/or 1099s or submission of copies requested from the taxpayer.

OBSERVATION: IRS verification programs have become increasingly aggressive. Most of these problems result from paper filing of information returns, such as Forms W-2 and 1099-NEC. Until these documents appear in the SSA database or IRS database, refundable credits are likely to be put on hold for “additional review.” With IRS staff stretched thin, significant postponements of taxpayer refunds may become more likely.

The Taxpayer Advocate Service (TAS) has indicated that dozens of programs have led to many refunds being placed on hold while the IRS attempts to verify the withholding amounts.

The TAS will initiate a hold program before it will assist taxpayers with these refund cases of four weeks. The hold period is to allow time for the IRS to review the necessary documents. While a taxpayer can obtain assistance from the TAS, the following procedures must be adhered to:

1. Reviewing the issue with the taxpayer, advising them to file the confirming documents or an amended/corrected return if necessary. Further action by the TAS will be held until a period of 4 weeks has passed after filing or submission.

2. If after the four-week period has passed and the IRS has not resolved the case, TAS will open a refund assistance case. Currently TAS has been indicating that most taxpayers do not require a case to be opened as the IRS has resolved the matter with its normal procedures.

VOLUNTARY IP PIN PROGRAM

An IP PIN is a six-digit number assigned to eligible taxpayers to help prevent the misuse of their Social Security number (SSN) on fraudulent federal income tax returns. An IP PIN helps the IRS verify a taxpayer's identity and accept their electronic or paper tax return. When a taxpayer has an IP PIN, it prevents someone else from filing a tax return with the taxpayer's SSN.

As a result of the Taxpayer First Act that required the IRS to make available to all taxpayers who wished to have an IP PIN the service in January of 2021 announced that if a taxpayer wishes to possess an IP PIN, they can apply for one. The IP PIN is a little like an MFA for your tax return, for those taxpayers who have an IP PIN associated with their account they must present an SSN and an IP PIN that are linked together.

A taxpayer who wishes to obtain an IP PIN can do so online. The IRS will assign an IP PIN to those taxpayers who have completed the application process. The notice of the IP PIN assignment will be sent to the taxpayer via notice CP01A.

The IRS has noted the following:

- <u>Tax professionals cannot obtain an IP PIN on behalf of clients.</u> Taxpayers must obtain their own IP PIN.

- <u>Taxpayers should only share their IP PIN with their trusted tax prep provider.</u> Tax professionals should never store clients' IP PINs on computer systems.

- <u>IRS will *never* call, email, or text either taxpayers or tax preparers to request the IP PIN.</u>

- <u>Taxpayers for whom a fraudulent return has been filed before they obtained an IP PIN should still obtain an IP PIN.</u> An IP PIN would still offer protections for later years and prevent taxpayers from being repeat victims of tax-related identity theft.

- <u>At the current time, taxpayers may obtain an IP PIN for 2021, which should be used when filing any federal tax returns during the year.</u> New IP PINs will be available starting in January 2022.

- <u>The IP PIN process for confirmed victims of identity theft remains unchanged.</u> These victims will automatically receive an IP PIN each year.

HOW TO GET AN IP PIN

The IRS released information on how to obtain an IP PIN in January 2021. As this manual went to press, there had been no further update.

Taxpayers who want an IP PIN should visit **www.irs.gov/identity-theft-fraud-scams/get-an-identity-protection-pin** and use the Get an IP PIN tool. This online process requires taxpayers to verify their identities using the Secure Access authentication process if they do not already have an IRS account. (See **www.irs.gov/individuals/secure-access-how-to-register-for-certain-online-self-help-tools** for further details.)

There is no need to file a Form 14039, an Identity Theft Affidavit, to opt into the program. Once taxpayers have authenticated their identities, their IP PIN immediately will be revealed to them. Once in the program, this PIN must be used when prompted by electronic tax returns or entered by hand near the signature line on paper tax returns.

All taxpayers are encouraged to first use the online IP PIN tool to obtain their IP PIN. Taxpayers who cannot verify their identities online do have options:

1. Taxpayers whose adjusted gross income is $72,000 or less may complete Form 15227, Application for an Identity Protection Personal Identification Number, and mail or fax it to the IRS. An IRS customer service representative will contact the taxpayer and verify their identity by phone. Taxpayers should have their prior year tax return at hand for the verification process.

2. Taxpayers who verify their identities through this process will have an IP PIN mailed to them the following tax year (the enrollment period is currently open for 2022). This is for security reasons.

3. Once in the program, the IP PIN will be mailed to these taxpayers each year.

Taxpayers who cannot verify their identities online or by phone and who are ineligible to file Form 15227 can make an appointment with the IRS to verify their identities in person at a Taxpayer Assistance Center. Taxpayers should bring two forms of identification, including one government-issued picture identification.

Taxpayers who verify their identities through the in-person process will have an IP PIN mailed to them within three weeks. Once in the program, the IP PIN will be mailed to these taxpayers each year.

NOTICES USED BY THE IRS FOR IDENTITY THEFT

The authors have attempted to provide thorough information on the Notices currently in use, but if information is needed on a particular (or new) Notice, tax practitioners should do the following:

1. Visit **www.irs.gov/individuals/understanding-your-irs-notice-or-letter**.

2. Use the Notice search tool on the page. The IRS has a habit of adding Notices to its collection before providing the details in Understanding Notices, so a sufficiently new Notice may not be listed.

Do not file Form 14039 if any the following forms have been received by the taxpayer or they have applied for a voluntary IP PIN:

1. **Letter 5071C.** The IRS received a tax return with a client's SSN and needs to verify their identity either based on action or badges of fraud. Try to register online and if that does not work call Identity Fraud at 800-908-4490.

2. **Letter 4883C.** This letter is to inform the taxpayer that the IRS needs more information to complete the processing of the return. If the taxpayer fails to contact the IRS, the return goes nowhere.

3. **Letter 5747C.** Call the IRS and schedule an appointment, they need to see you in person.

4. **Letter 5073C.** The IRS is confirming they have received an identity theft report and or documentation the taxpayer has filed with the Service.

5. **Letter 4310C.** The IRS is notifying the taxpayer they believe someone else (not the taxpayer) has attempted to file a return. The tax return referenced in this letter will not be processed.

6. **Letter 239C.** This is primarily a notice informing the taxpayer that he or she may be a victim and an indicator has been placed on the account.

7. **CP01.** The IRS is confirming they have placed an identity theft indicator on the account.

8. **CP01A.** This is the IP PIN notification letter. It also explains how the taxpayer is to use the IP PIN. Go to **www.irs.gov/individuals/understanding-your-cp01s-notice%20**if the IP PIN notice does not arrive.

9. **CP01B.** The IRS needs more information to correctly process the return.

10. **CP01C.** This notice is an acknowledgment of receipt of standard identity theft documentation and to inform them their account has been marked with an identity theft indicator.

11. **CP01E.** Issued to victims of identity theft because someone other than the valid Social Security number (SSN) owner used the taxpayer's SSN and possibly their personal information for employment.

12. **CP01S.** The IRS has received either Form 14039 or a statement regarding the taxpayer's identity theft claim. Normal compromised account processing will ensue. If additional information is required, the IRS will contact the taxpayer.

WHERE TO GO FOR MORE INFORMATION

- Searchable list of data breaches: **https://oag.ca.gov/privacy/databreach/list**
- IRS resources:
  - IRS Identity Theft Information for Tax Preparers (**www.irs.gov/individuals/identity-theft-information-for-tax-preparers**)
  - IRS Taxpayer Guide to Identity Theft (**www.irs.gov/newsroom/taxpayer-guide-to-identity-theft**)
  - IRS Publication 4524, *Taxes. Security. Together*.
  - IRS Publication 4557, *Safeguarding Taxpayer Data 4557*
  - IRS Publication 5293, *Protect your Clients, Protect Yourself*
- FTC Safeguard Rules (**www.ftc.gov/tips-advice/business-center/guidance/financial-institutions-customer-information-complying**)

CHAPTER 20: IRS UPDATE

Learning Objectives

Completion of this chapter will enable participants to—

- Recognize critical changes that occurred to procedures when working with the IRS.
- Identify what steps can be taken to overcome IRS processing issues.

IRS BACKLOG OF RETURNS

"Where is my refund?" is an all too frequent call. It has been reported by several news agencies and the Treasury Inspector General for Tax Administration (TIGTA) that as of July 2021, the backlog numbered around 35 million returns. The IRS reported on August 13, 2021 that the current processing backlog as of August 6, 2021 was 12.7 million individual returns, indicating that these returns represent filings that require some level of physical processing. There is also a belief by many tax professionals that the delayed processing is also a result of the IRS's lowered thresholds for suspected tax refund fraud. As of August 23, 2021, the IRS stated they are opening their mail "timely."

"How long they will need to wait?" The IRS has issued the following statement on its website:

> We have processed all error-free returns received prior to April 2021 and continue to work the returns that need to be manually reviewed due to errors.* We are continuing to reroute tax returns and taxpayer correspondence from locations that are behind to locations where more staff is available, and we are taking other actions to minimize any delays. Tax returns are opened and processed in the order received. As the return is processed, whether it was filed electronically or on paper, it may be delayed because it has a mistake including errors concerning the Recovery Rebate Credit, is missing information, or there is suspected identity theft or fraud. If we can fix it without contacting you, we will. If we need more information or need you to verify that it was you who sent the tax return, we will write you a letter. The resolution of these issues could take **<u>90 to 120 days</u>** depending on how quickly and accurately you respond, and the ability of IRS staff trained and working under social distancing requirements to complete the processing of your return.

Note:

***** Returns the IRS deems "error-free" can still be delayed by other procedures, such as refund fraud trapping; look for Letter 5071C.

> **OBSERVATION:** Paper filed documents have become an increasing target of IRS fraud trapping procedures. In many cases of taxpayers reporting excessive refund delays, there is a combination of two items: first, a refundable credit, and second, a paper filed W-2 or Form 1099-NEC.

ONLINE SUBMISSION OF FORMS 2848 AND 8821

In January 2021, the IRS launched a new online tool known as "Submit Forms 2848 and 8821 Online." This new tool will allow tax professionals who are working with clients to remotely obtain their clients' electronic signatures and to electronically upload Forms 2848 and 8821 to the IRS.

Tax professionals may go to their Tax Pro Account to digitally initiate POAs and TIAs. Once completed and submitted by the tax professional, the authorization requests will appear in the taxpayers' Online Account for their review, approval and electronic signature, or rejection. Because the taxpayers' identities are already verified at the time of login, taxpayers need only check a box as their signature and submit the authorization request to the IRS. Currently, the digital authorization process is available only to individual taxpayers, not businesses or other entities.

In July 2021, the IRS enhanced its online process with the Tax Pro Account. The Tax Pro Account's initial functionality will allow tax professionals to initiate what the IRS refers to as a "third-party authorization" online and send it to a client's IRS online account. Individual clients will be able to access their online account and digitally sign the authorization, sending it to be recorded on the IRS's Centralized Authorization File (CAF). This will provide an opportunity for practitioners to record the filing of Form 2848 or 8821 within hours instead of weeks or months.

The Tax Pro Account can be accessed at **www.irs.gov/tax-professionals/use-tax-pro-account**. An update to Forms 2848 and 8821 emphasize that the use of the Tax Pro Account will speed up processing of the forms.

In recent publication "Closer Look," the IRS admitted that the recent pandemic clearly demonstrated how deficient IRS online processes were. The advantage of the new process is that practitioners can initiate the "filing" of Forms 2848 and 8821 by sending a request to the taxpayer's Secure Access account. The taxpayer then accesses their own Online Account, selects the "Authorization" tab at the top, and can either reject or accept and digitally sign the request. When the taxpayer submits the signed request, if the request information is accurate and the tax professional is in good standing with the IRS, the POA or TIA will generally record immediately to the CAF database—though recording could take up to 48 hours. Approved online POAs and TIAs display in both the Tax Pro Account and the Online Account.

It should be noted that the IRS requires all tax professionals to obtain a Secure Access account (visit **www.irs.gov/individuals/secure-access-how-to-register-for-certain-online-self-help-tools** for information on creating a username and password to use IRS e-applications such as E-Services or Tax Pro Account). The following information is required to register on Secure Access:

- Email address
- Social Security Number (SSN) or Individual Tax Identification Number (ITIN)
- Tax filing status and mailing address
- One financial account number linked to the user's name:
  - Credit card – **last 8 digits** (no American Express, debit, or corporate cards), or
  - Student loan – (Enter the student loan account number provided on the user's statement. The account number may contain both numbers and letters. Do not include any symbols. Additionally, student loans issued by Nelnet *cannot* be used for verification.), or
  - Mortgage or home equity loan, or
  - Home equity line of credit (HELOC), or
  - Auto loan

- Mobile phone linked to the user's name (for faster registration) or the ability to **receive an activation code by mail**.

After the passage of the Taxpayer First Act, the IRS has been aggressively pursuing an e-service strategy. Many services are currently available from the IRS in their e-format, with more to follow. In past presentations to several industry trade groups, IRS Commissioner Charles Rettig has lauded the IRS e-services strategy, sharing visions of future products that he believes will greatly enhance the ability of the IRS to allow customers to more frequently self-service their problems.

The operational procedures filing Forms 2848 via the Tax Pro Account differ from the paper process. Accordingly, the IRS updated IRM 21.2.1.63 to reflect those operation changes. In most circumstances, there will be little or no notable differences; however, there is a significant change when multiple individuals are being listed on the POA. In the past, the submission of a new POA would negate a prior POA unless it is noted that the submission represents an additional representative. The following example has been provided in the updated IRM procedure:

> **EXAMPLE:** Enrolled agent Grayson Smith has authority on taxpayer Mary Johnson's account for tax years 2000–2018. A new request for authority is made for 2017–2024 by Michael Williams, CPA on Mary Johnson's account on the Tax Pro Account portal. Once the request is processed, Grayson Smith will only have authority for 2000–2016, as Michael William's request via Tax Pro Account will invalidate Grayson's authorization for 2017 and 2018. To preserve Grayson Smith's authority on 2017–2018, Mary Johnson will have to file a Form 2848 or Form 8821, check the box to maintain a prior authorization, and include a copy of Grayson Smith's authorization.

Only two individuals may receive notices for the taxpayer; if the taxpayer requests greater than two representatives to receive notices, all representatives after the first and second will be ignored. The IRS has yet to provide guidance on how to change which representatives receive taxpayer notices.

In a "Closer Look" conversation, the IRS provided some additional clarification regarding the use of the Tax Pro Account functionality:

- Taxpayers can authorize multiple representatives/designees.
- The function includes IRS e-authentication for both the taxpayer and the representative/designee.
- Using Forms 2848 and 8821 for third-party authorizations remains an option for those individual taxpayers who do not have or are unable to register for an Online Account, who have more complex tax matters requiring the use of a form, or for business taxpayers. These forms can be uploaded using "Submit Forms 2848 and 8821 Online" as well as e-faxed or mailed.

LEVEL OF AUTHORITY FOR IRS-ISSUED FAQS

Not infrequently, the IRS is asked to defend its extensive use of Frequently Asked Questions (FAQs), providing guidance which has proliferated since enactment of the TCJA and particularly during the relief measures associated with the pandemic. At a conference sponsored by New York University, acting IRS Chief Counsel William M. Paul addressed several concerns regarding FAQs the IRS issues. One issue addressed was the extent to which practitioners and taxpayers may rely on FAQs.

Mr. Paul said that there is an IRS working group that has been considering various aspects of FAQs, including the extent to which practitioners and taxpayers may rely on them, further stating—

> IRS is comfortable with the view that if a taxpayer relies in good faith on an FAQ and that reliance is reasonable under all the facts and circumstances, the taxpayer should have a reasonable cause defense and should not be subject to a negligence penalty or other accuracy-related penalty. [. . .] IRS won't assert FAQs in support of its positions on audit or in litigation. [. . .] The flip side of that is that if an FAQ is incorrect as applied to a particular taxpayer's facts, then the law will control.

The Chief Counsel also indicated that IRS hopes to soon unveil a system that will archive FAQ guidance. Users of the new system will be able to search for FAQs and see the ways in which they may have been edited by IRS:

> We're going to find a way to archive them so that you can keep track—you can go find an FAQ, there'll be a system to do that—at least that's our hope. [. . .] And if an FAQ gets modified, there'll be a way to see what it said before the change and on what date.

OBSERVATION: Since the IRS adopted the use of FAQs, whenever a tax position relies on a FAQ, a copy of the FAQ should be kept in the client's file. Based on the recent statement by Chief Counsel Paul, this practice is an important part of what a practitioner should do when relying on this type of IRS guidance.

APPEALS REQUIRES VIRTUAL CONFERENCES AVAILABILITY

A fundamental right of taxpayers is the appeals conference. Most taxpayers with an active tax controversy can request a conference with Appeals to try to settle their tax controversy [IRC Sec. 7803(e)(4)] An important part of the appeals conference right is to hold that conference in person. However, Appeals have not held an in-person appeals conference since the beginning of the pandemic.

When distance and time constraints make in-person conferences impractical, Appeals has historically encouraged the use of teleconferencing to conduct appeals hearings, but now with the pandemic, the fate of the in-person appeal seems all but sealed. Many practitioners have felt that this process somehow lacked a necessary ingredient to be an effective advocate for their client. Steve Jobs once said, “Not only do in-person meetings tend to be more positive, they also tend to be more productive.” Many business psychologists insist that it is more difficult to tell somebody no to their face than it is through a letter or a faceless phone call.

OBSERVATION: Your author has not had an opportunity for a face-to-face appeals conference for several years, as the nearest appeals office is an 11-hour round trip. The offering of virtual conferences is an exciting opportunity to provide more effective representation for my client.

An Appeals employee is required to offer and conduct a virtual conference if the taxpayer (or their representative) has requested one. In addition, the Appeals employee should offer a virtual conference if the taxpayer (or their representative) has requested an in-person conference, but that request can't be accommodated by Appeals.

Appeals employees are not required to offer a virtual conference when a taxpayer (or their representative) has requested a phone or correspondence conference. In this case, the Appeals employee should use their judgment and experience to determine whether to voluntarily offer a virtual conference to that taxpayer.

USE OF ELECTRONIC DELIVERY AND RECEIPT BY IRS

As a result of the pandemic, the IRS—to the degree they are capable—allowed a greater reliance on "electronic communications." This was part of a Presidential emergency declaration signed on May 13, 2020. In several notices since that date, the IRS has indicated that the use of email was allowed in circumstances where the IRS worker had agreed to the delivery of documents in that manner prior to the documents being sent.

Per the emergency declaration, pursuant to the Robert T Stafford Disaster Relief and Emergency Assistance Act the IRS, as well as other governmental agencies, were instructed that they could allow the receipt and transmission to taxpayers using SecureZIP (encrypted email) or other authorized secured messaging systems. This order initially expired on July 15, 2020, but was extended several times, and currently can be relied upon until December 31, 2021.

Documents Affected

The documents affected by the temporary procedures include—

- extensions of statute of limitations on assessment or collection;
- waivers of statutory notices of deficiency and consents to assessment;
- agreements to specific tax matters or tax liabilities (i.e. closing agreements); and
- any other statement or form needing the signature of a taxpayer or representative traditionally collected by IRS personnel outside of standard filing procedures (for example, a case specific Power of Attorney).

Acceptance of Digital Signatures and Signature Images

According to the memorandum, IRS employees may temporarily accept images of signatures (scanned or photographed) in one of the following file types: TIFF, JPG, JPEG, PDF, Microsoft Office suite, or Zip. IRS employees may also accept digital signatures that use encryption techniques to provide proof of original and unmodified documentation on the following file types: TIFF, JPG, JPEG, PDF, Microsoft Office suite, or Zip.

IRS Receipt of Documents by Email

The memorandum states that if a taxpayer or representative uses email to transmit documents to an IRS employee, the IRS employee must take certain precautions to protect the taxpayer's sensitive information including, authenticating the identity of the taxpayer or the taxpayer's representative, advising the taxpayer or representative that sending unencrypted email over the internet is not secure, and warning the taxpayer to keep sensitive information out of the subject line or body of the email.

Taxpayers or representatives using email to transmit documents to the IRS must also include a statement, in a cover letter or in the body of the email, that the document being emailed contains the taxpayer's valid signature and the taxpayer intends to transmit the document to the IRS.

Transmitting Documents Electronically to a Taxpayer

According to the memorandum, an IRS employee may, with the taxpayer's consent, transmit documents to the taxpayer using SecureZIP or another IRS authorized secure messaging system. The memorandum notes that IRS employees must take certain precautions to protect sensitive taxpayer information when using email, including getting a test email from the taxpayer to confirm the taxpayer's email address, keeping sensitive taxpayer information out of the subject line and body of the email, and using a 12-character password to secure any document(s) attached to the email.

In a memo dated June 9, 2021, the IRS Appeals Division stated that, because of the Coronavirus (COVID-19) emergency and in accordance with IRC Sec. 7803(e)(7) ("access to case files" rules), Appeals Technical Employees (ATEs) are now authorized to receive and transmit documents by SecureZIP to taxpayers and their authorized representatives through December 31, 2021. The IRS has said that the IRMs will not be adjusted to permanently reflect this change.

The Taxpayer Advocate Service announced the same electronic communication initiative in a memo dated May 17, 2021, extending a COVID-19 electronic communication policy that was set to expire on June 30, 2021.

OBSERVATION: The electronic delivery of documents to the IRS has been a desire for many years. Many in the tax community are encouraged by IRS's extensions on the use of electronic document delivery. The IRS is evaluating procedures to "allow" use of email to conduct regular business. Currently, the system is under the third extension of the initial order that allowed the use of email. Old habits die hard, and while practitioners are now effectively using email to resolve IRS issues, many practitioners remain resistant to change.

NOTE: Appeals and TAS are more suited to email than other divisions in the Service, which explains why there has been a broader adoption of email by Appeals and TAS.

COURT CASES: THE IMPORTANCE OF A SIGNATURE AND TIMELY FILING

Signing a return or claim seems like an easy process, but not so for the Browns. IRC Sec. 6061 requires that every return be signed in accordance with IRS Regulations. *George P. Brown, et al. v. United States* (Ct Fed CL 12/15/2020 126 AFTR 2d 2020-5567) also spoke to the importance of a refund claim being signed in compliance with IRC Sec. 7422(a). Whether failure to timely signed can be repaired at a later date was the subject of the *Brown* case.

George Brown and Ruth Hunt-Brown filed tax returns, and then amended tax returns, for the 2015 and 2017 tax years. The amended returns claimed refunds. The returns were signed by their return preparer, John Castro, but were not accompanied by the required Form 2848. On November 15, 2018, Castro submitted a Form 2848 purporting to authorize him to sign the Browns' returns, but this form was not signed by the Browns. On April 26, 2019, the IRS disallowed these claims. However, the IRS rejected the refund claims based on the IRS's position that the returns were not signed.

The IRS moved to dismiss the Complaint, arguing that the court lacked jurisdiction because the Browns had failed to verify their administrative claims for refund, that they had not signed their returns, and that they had failed to properly authorize a representative to sign on their behalf. The Browns responded that the IRS had waived the taxpayer signature requirement by accepting their returns. The Court agreed with the IRS that it cannot waive the signature requirement and accordingly dismissed the case.

In the case of *Susan M. Libitzky v. United States* (Northern District of California), the question presented was whether a timely refund claim was filed. For Tax Year 2011, the question was a determination of the due date of the return. While Ms. Libitzky filed a refund claim based on an extended due date of her 2011 return, she could not prove that the extension was filed and could not provide any kind of certified mail receipt or other proof of extension filing. At the conclusion of the case, the court ultimately could not determine whether the 2011 return was extended, and denied refunds totaling almost $700,000. This was caused by the inability of the taxpayer to prove timely filing.

IDENTIFY INFORMATION NEEDED WHEN CALLING THE IRS

In Tax Tip 2021-110, the IRS reported issues associated with taxpayers and tax professionals who call the IRS not having the necessary information available. For several years (since 2018), the IRS has had specific protocols for the purpose of determining a caller's identity. It has been reported that there is a growing issue of a failure to be able to identify a caller, so the IRS asks that the taxpayer and/or tax professional have the following information available:

- The Taxpayer:
    - Social Security numbers (SSN) and birth dates for those who were named on the tax return
    - An Individual Taxpayer Identification Number (ITIN) letter if the taxpayer has one instead of an SSN
    - Their filing status: single, head of household, married filing joint or married filing separate
    - The prior-year tax return. Phone assistors may need to verify taxpayer identity with information from the return before answering certain questions
    - A copy of the tax return in question
    - Any IRS letters or notices received by the taxpayer
- Additional Info needed by the Tax Professional:
    - Verbal or written authorization from the third-party to discuss the account
    - The ability to verify the taxpayer's name, SSN or ITIN, tax period, and tax forms filed
    - Preparer Tax Identification Number or PIN if a third-party designee
    - One of these forms, which is current, completed, and signed: Form 8821, Tax Information Authorization Form 2848, Power of Attorney and Declaration of Representative

OBSERVATION: While the IRS indicates that a verbal authorization should be sufficient to allow IRS to discuss the matter with the taxpayer's representative your author has increasingly noted that there is an insistence that a Form 2848 or Form 8821 be on file. As filing of Forms 2848/8821 have been streamlined by the Tax Pros Account, best practice would seem to be to get the authorization on file, facilitating receipt of future notices regarding the matter.

FILING FORM 1040-X VIA E-FILE

In a major initiative that has been in the hearts, souls, and prayers of practitioners for many years, the IRS announced in IR-2020-107 (05/28/2020) that Form 1040-X would finally be joining the e-file family in late summer 2020. The project was not given much attention since relatively few amended returns (the IRS currently estimates about 3 million) are filed each year. At this time, only 2019 and 2020 amended returns can be e-filed, 2021 will be added after the filing has been initiated for the 2021 tax year. Form 1040-X will be added sometime after March or April 2022. An ongoing issue of misunderstanding has been the addition of older years being added to the 1040-X e-filing family; however, as this manual went to press, the IRS had not published plans to add any years prior to 2019.

SUPERSEDING RETURNS

The superseding return is used by taxpayers as a "replacement" of an earlier return that has been filed but for which the due date (including extensions) has not passed. That contrasts with the *amended* return, which is considered a modification of the earlier return that changes some amount or tax position taken on the initial return. Recent Chief Counsel Advice 202026002 challenges that assumption, concluding that a superseding return does not replace an original return when determining the statutes of limitation for assessments and for the filing of refund claims (i.e., the original return will determine the filing date of the return). This determination was reached based on two older Supreme Court cases, *Zellerbach Paper Co* [293 US 172 (1934)] and *National Paper Products* [293 US 183 (1934)]. This ruling has thrown the technical placement of the superseding return in disarray.

Example: Determining the assessment and refund claim period after filing a superseding return

A taxpayer received an extension to file his 2021 tax return until October 15, 2022. On September 20, 2022, he timely files an original return, and then files a timely superseding return on October 15, 2022. Under CCA 202026002 and the IRM, the original return filed on September 20, 2022 would start both the assessment and refund claims periods.

Note that CCA 202026002 does not destroy the value of filing the superseding return for purposes of—

- Adding an election that is required to be filed with the initial return.
- Changing an election that was made on the original return
- Changing an estimate application election (i.e., modifying a request to apply an overpayment versus refund of that overpayment).
- Fixing an error, such as the failure to attach a specific form, such as Form 3115.

A superseding return must be paper filed and must include all forms and required elections. It must be noted on the filing that it is in fact a superseding return.

CAUTIONERY NOTE FOR 2019 AND 2020 REFUND CLAIMS FILED AFTER 04/15/2021

The National Taxpayer Advocate (NTA) has cautioned that taxpayers who file a claim for refund after April 15 for tax years 2019 or 2020 may have a timely filed claim, but the amount of the refund may be unexpectedly limited to $0 (effectively denied) in 2023 or 2024 because the IRS postponed the filing deadlines in 2020 and 2021 rather than extending them.

EXAMPLE: Effect of postponed 2021 filing dates on future refund claims

In 2019, Timmy Boy (TB) was a W-2 employee and had income tax withheld from his paycheck every two weeks. TB filed his 2019 return on June 25, 2020. TB then files a claim for refund on June 26, 2023. As June 25 is a Sunday in 2023, the claim for refund is timely. However, the withholding taxes were deemed paid on April 15, 2020. Under the three-year lookback rule, these amounts are only available for refund until April 18, 2023 (as April 15, 2023, is a Saturday, and April 17, 2023, is when Emancipation Day is observed), so TB's claim for refund will be denied.

A similar outcome can be expected for 2020 returns: if a taxpayer filed a 2020 return on May 17, 2021, pursuant to Notice 2021-21, the taxpayer could file a timely claim for refund by May 17, 2024, but if they did so, they would not get a refund of the withholding deemed paid on April 15, 2021, as the withholding would be outside the three-year look-back period.

PRACTICE ALERT: Create a reminder to file refund claims, with respect to 2019/2020 individual returns (and other postponed-due-date 2019/2020 returns) for which no extension was filed, by April 18, 2023/April 15, 2024, and create a reminder to file refund claims with respect to 2020/2021 individual returns.

FAXING AND SIGNING RETURNS FOR THE IRS

The general rule is that you cannot fax a tax return to the IRS. Many a taxpayer has learned this rule at the worst possible time. In a recent case, *Seaview Trading LLC* (TC Memo 2019-122), the taxpayer discovered that the faxing of a Form 1065 to the IRS did not qualify as a filing of a return and did not start the statute of limitations.

Per a request by a Revenue Agent, the accountant for Seaview faxed a copy of the purported return in July 2002. In 2010, the IRS assessed additional taxes against the taxpayer for 2001. The taxpayer argued that the return submitted to the IRS in 2002 by fax started the statute of limitations. The IRS countered that faxing a return was not properly filing a return. The Tax Court agreed with the IRS, allowing the Service to assess the additional tax in 2011.

OBSERVATION: It is common for the IRS to request a copy of a return during a compliance project, but any return sent to an address other than the required filing address should be stamped "COPY". In the event the taxpayer has been asked for a return during a compliance encounter, determination should be made as to whether a return was filed with the IRS or if no record of filing exists. If uncertain, and a paper return needs to be filed, visit Where to File at **www.irs.gov/filing/where-to-file-paper-tax-returns-with-or-without-a-payment** to determine the current filing address.

During the pandemic, certain return filings by fax were specifically authorized, such Forms 1139 and 1045. These fax filings were meant to facilitate NOL carrybacks during the pandemic closures at IRS service centers. however, the aforementioned forms were only allowed for CARES Act NOL carrybacks and carryforwards. Subsequently, the IRS indicated that the IRS copy of Form 3115 (Rev. Proc. 2020-29) was to be faxed. After that announcement, the IRS announced several other forms could be faxed, setting up specific numbers for these forms which will remain effective until the IRS announces that faxing will be discontinued.

Current guidance is that the following Forms are to be faxed to the numbers indicated:

- Forms 1139 and 8829: 844-249-6236
- Form 1045: 844-249-6237
- E-File Application Appeals: 877-477-0567
- Form 8886: 844-253-2553
- Form 3115: 844-249-8134

Additionally, IRS has indicated the following Forms which traditionally required wet ink signatures could be signed electronically (these are the returns that currently cannot be filed electronically). Guidance on this issue has be sporadic with several extensions. As this manual went to press, December 31, 2021 is the expiration, but the expectation is that this change may continue (see related information following).

- Forms 706 and 706-NA
- Form 709
- Form 1066
- Form 1120-C
- Form 1120-L
- Form 1120 ND
- Form 1120-PC
- Form 1120-REIT
- Form 1120-RIC
- Form 3115
- Forms 3520 and 3520-A
- Form 8453: All Returns
- Form 8802
- Form 8832
- Form 8878: All Returns
- Form 8879: All Returns

TAXPAYER FIRST ACT REPORT TO CONGRESS

In July 2019, the Taxpayer First Act (TFA) was signed with an attempt to "reimagine" what taxpayer service could look like at the IRS. There is little disagreement that the service abilities of the IRS have fallen into complete chaos, with an immediate need to fix the agency. The hiring of Charles Rettig, the first tax professional heading the agency since 1997, coupled with the service initiatives of the TFA, have the goal of fixing the agency. One of the requirements of the TFA was an annual report—254 pages (**www.irs.gov/pub/irs-pdf/p5426.pdf**)—informing Congress of the status of the IRS in addressing the mandates of the TFA.

As required, the delivery of the first report occurred in January 2021, notably in the middle of the disarray of the pandemic. On page 15 of the report, the IRS's view of the status of the changes to the Service are important comments and insights on the status of tax administration in the country (emphasis added):

> This report describes how we can transform the IRS into a modern, efficient, and **taxpayer centric centered agency**. One that is **easily accessible for all taxpayers**, including traditionally underserved communities. The report outlines three strategies that build upon one another: Taxpayer Experience, Training and Organizational Redesign. Our Taxpayer Experience, Training, and Organizational Redesign Strategies will **re-shape the IRS into a nimbler enterprise**, readily capable of taking advantage of emerging technology. These strategies are built upon the exceptional work the IRS is already doing, but in many other ways, they are **aspirational**. We intend for the strategies described in this report to reimagine the taxpayer experience. Our strategies will guide our future strategic planning efforts and we will continue to coordinate across the agency to align on new initiatives.

The challenges to the IRS are constantly evolving. In 1975, the Service was first tasked with the administration of the Earned Income Tax Credit program, which has undergone significant changes through the years. In 2020, the IRS was tasked by Congress to deliver financial aid to Americans using the Economic Impact Payments in an effort to ease the financial suffering brought on many by the pandemic. Now the agency is assisting with the Advance Child Tax Credits. Meanwhile, the practitioner community struggles to resolve issues with an overburdened agency.

To create a new IRS—which means tax practitioners will need to relearn how to navigate the agency—the Service says it will—

- <u>Expand Digital Services</u> to provide self-service channels by building on existing online accounts and introducing online accounts for tax professionals and business taxpayers.

- <u>Seamless Experience</u> to guide taxpayers to the resources and communication channels that will resolve their issues.

- <u>Proactive Outreach and Education</u> to educate taxpayers by providing information at the time, in the language, and by the method they prefer through applying behavioral insights, using new technology, and continuing to use and expand upon our trusted partnerships.

- <u>Focused Strategies for Reaching Underserved Communities</u> to consolidate programs that engage with these communities to address communication, education, transparency, trust, and other constraints some face in accessing information and services.

- <u>Community of Partners</u> to establish, guide and facilitate a collaborative and interactive network of partnerships across and beyond tax administration—including the public, private, and nonprofit sectors—to share best practices and amplify our ability to reach taxpayers with the information they need.

- Enterprise Data Management and Advanced Analytics to develop a data management strategy that includes an agency-wide understanding of the taxpayer experience, emerging needs and expectations, and operational data.

Stay tuned for the launch of the Starship Internal Revenue Service, which will take us to bold new worlds where no taxpayer or tax practitioner has been before.

UPDATING THE TAXPAYER'S OFFICIAL ADDRESS WITH THE IRS

In *Gregory v. Comm.* (152 T.C. No 7), the court was charged with determining what constitutes notice of address change with the IRS. The last known address for the IRS is the address on the last "tax return" filed by the taxpayer. In *Gregory*, the taxpayers argued that Form 2848 and Form 4868 constituted a return for purposes of "last known address." The taxpayers had incorrectly listed their prior address on their 2014, return which was selected for exam. During the deficiency procedures, the IRS sent a 90-day letter (SND) to the old address, which subsequently failed to reach the Gregorys in a timely manner for purposes of filing a Tax Court Petition.

OBSERVATION: The filing of Form 8822/8822-B should be incorporated into standard practices of every firm. When notified by a client of a change in their address or ownership of their enterprise, practitioners should ensure Form 8822/8822-B is completed and mailed to the address provided by the IRS. The *Gregory* case reinforces how important timely notification and proper manner of notification to the IRS is.

The court pointed to Rev. Proc. 2010-16, which explicitly indicated that Form 2848 and Form 4868 were not returns, for purposes of informing the IRS of a current address. Forms 8822 and Form 8822-B (Change of Responsible Party) contain the regulatory necessary information. Best practices demand that whenever the taxpayer makes an address change, the appropriate Form 8822/8822-B should be filed. The standard is "clear and concise notification." Due to the numerous conflicting rulings on the matter, it is critical that Form 8822/8822-B be filed with the commissioner. The IRS recently updated Topic No. 157 regarding change of address (**www.irs.gov/taxtopics/tc157**).

Per the IRS, "clear and concise notification" requires the following:

Must Be in Writing.

You may also write to inform us that your address is changing. Tell us you're changing your address by providing us your:

- Full Name
- Old and New addresses
- Social Security Number, Individual Taxpayer Identification Number, or Employer Identification Number, and
- Signature

  - Joint Filers – If you filed a joint return, you should provide the information and signatures for both spouses. Send your written address change information to the IRS addresses listed in the instructions to the tax forms you filed.

  - Separated – If you filed a joint return and you now have separate residences, each joint taxpayer should notify us of your new, separate addresses.

- Employment Tax Returns

If the change of address relates to an employment tax return, the IRS issues confirmation notices (Notices 148A and 148B) for the change to both the new and former address.

While there are checkboxes to indicate a change in address on Forms 1120, 1120S, and 1065, there is nowhere to indicate the prior address. This information deficiency fails the "clear and concise" standard which requires notice of both the *Old Address* and *New Address*, which are only found on Form 8822/8822-B.

Form 8822-B is more than just the "business return" version of Form 8822; the form contains not only notification of business mailing address change, but also notification of changes to—

- Business Location

- Identity of the responsible party

Note: these changes are to be reported within 60 days of such a change

Where to file Form 8822/8822-B can be found on the form.

THE MAILBOX RULE IN THE TIME OF COVID-19

We know that tax returns and documents mailed to the IRS during 2021 sat in mail facilities for an extended period. Not to panic, however, because the mailbox rule (IRC Sec. 7502), if followed precisely, will protect the timeliness of the filing or delivery of the document.

Notice 2016-30 provides a listing of the postal delivery services (PDS) which will ensure that the day the taxpayer places the document in the hands of the delineated service will be considered the day of filing (delivery).

If a taxpayer uses a non-designated PDS (thus making the mailbox rule unavailable), then the tax document must be received by the IRS on or before the due date to be considered timely. When a taxpayer does not satisfy the requirements of the Mailbox Rule, a tax document is considered filed on the date it is received by the IRS. [*American Valmar Int'l Ltd.*, (CA 2 2000) 86 AFTR 2d 2000-6362].

When the tax document is sent first class mail via USPS, the taxpayer has the burden of proof of both the timeliness and delivery to the IRS [*Wood*, (CA 8 1990) 66 AFTR 2d 90-5987].

Mailing by enhanced services (designated a PDS) such as UPS, Federal Express, or DHL meets the burden of proof of timely filing and delivery.

A tax document (excluding a payment) sent by USPS registered mail, USPS certified mail, or by a designated PDS will be *prima facie* evidence that the document was delivered. [IRC Sec. 7502(c)(1); Reg. §301.7502-1(e)(2)].

To meet the Mailbox Rule in its entirety, the tax document must follow the mechanical rules of IRC Sec. 7502:

1. The envelope and address must be proper,
2. It must be timely deposited in the U.S. mail, and
3. The postmark must be applied consistent with Reg. §301.7502-1(e)(2).

EXAMPLE: PDS record as *prima facie* evidence of timely filing

Lexie uses UPS 2nd Day Air to send her tax return to the IRS. The filing is due July 15. The return is delivered to the IRS on July 18. The postmark date for Lexie's return is presumed to be July 16, two days before the actual delivery date for two-day service. To overcome this presumption and establish that the return was timely, Lexie must show that the date recorded in UPS's electronic database is on or before July 15 (i.e., a UPS receipt reflecting that UPS received her tax return for shipping on or before July 15).

COURT CASE: Occasionally, the mail system completely breaks down and normal delivery dates fail to match up with reality. In *Seely* (TC Memo 2020-6), the taxpayer's attorney produced a sworn affidavit indicating that his office had mailed the tax document to the court on 06/26/2017. The court received the tax document on 07/17/2017, but the problem was the post office never affixed a postmark.

Both the government and the taxpayer agreed that from the attorney's location the normal delivery time was 8–15 business days, but it arrived 16 business days after mailing. The IRS argued that the rules under IRC Sec. 7502 applied, indicating that the attorney's sworn statement was not credible evidence.

The court did not find the IRS's argument persuasive, noting that the tax document was only a single day late. Additionally, there were other circumstances that could have easily impacted the delivery, such as, the July 4th holiday, holiday closures, staffing issues, or even a mail inefficiency.

OBSERVATION: As a result of the COVID-19 pandemic, is it highly probable that we will experience mail delays. Recently, the author had a difficult time in dealing with an IRS agent due to documents addressed to the agent being stored in a "temporary location." CNN has reported that the IRS has numerous trailers in its parking lots loaded with unopened mail. It is the author's expectation that it will take numerous attempts to remedy normally routine issues over the next year because of the COVID-19 shutdown.

In normal times, most tax offices send time sensitive documents by certified or registered mail. Due to COVID-19 staffing issues, some offices only allow for depositing mail to an unattended mailbox with the hope that postal staff would affix the appropriate postmarks.

Practitioners in this predicament should document placing tax documents in the mailbox to the best of their ability (e.g., photographically using a smartphone). It is our expectation that while there will be a considerable amount of flexibility, problems are likely.

COURT CASE: Under the postmark rule, a tax document is deemed to have been filed on the date of mailing. In *Harrison* (DC WI 01/09/2020), the taxpayer mailed a 2012 return (filed valid extension) via certified mail on 10/11/2016. The return was received by the IRS on 10/17/2016.

The IRS denied the refund claim, citing there were no taxes paid during the claim period, as the filing date of the claim was 10/17/2016, which was the date received (and beyond the three-year statutory period), as taxes were considered paid on 04/15/2013. Initially the court agreed with the IRS, as neither the IRS nor the taxpayer mentioned Reg. §301.7502-1(f)(1).

Twenty days later, the taxpayer motioned the court to reconsider seeking the applicability of purging of e-services account by the IRS.

OBSERVATION: Waiting until the last possible moment to file a late return has never been a good idea. With the IRS denying the Harrison refund claim, we have entered a period where filing toward the end of the refund statute can be detrimental. The District Court of Wisconsin was able to override this error, but will the IRS try again?

ADVICE FOR PRACTITIONERS WORKING WITH THE TAXPAYER ADVOCATE SERVICE (TAS)

Congress has made a commitment to improving interactions with the Taxpayer Advocate Service (TAS) by both taxpayers and practitioners. When the TAS was first conceptualized by Congress back in 1998, the intent was to create an ombudsman who could help customers of the IRS when they were struggling with the IRS bureaucratic complexities.

Nina Olson was at the helm of the TAS for over 20 years, with Erin Collins taking over the organization when Nina retired in 2019. However, Nina's relationship with the IRS was rocky most of the time. As Ms. Collins puts her stamp on the agency, she is also operating with a Congress who has determined that the IRS is badly damaged. The new National Taxpayer Advocate has taken a firm hand on the helpful mission of the agency. Once again, it appears that the TAS is a good place to take problems of the tax community.

The TAS indicates that they should be contacted when:

1. The case meets their criteria (see **https://taxpayeradvocate.irs.gov/can-tas-help-me-with-my-tax-issue**)
2. A systemic problem is identified that is causing continuing problems when working with the IRS.

When working with them, the TAS will—

1. Assign a case advocate for the duration of the case.
2. Contact the practitioner within seven days after the date the practitioner contacts the TAS.

3. Provide an estimated completion date for case resolution.

When trying to solve the unsolvable, the TAS is once again a promising resource. Practitioners should call them at 877-777-4778 or visit the website to obtain specific information for their state (**https://taxpayeradvocate.irs.gov/contact-us**).

CHANGES TO THE TRANSCRIPT PROCESS

To protect against identity theft, the IRS will no longer fax transcripts to taxpayers, tax professionals, and third parties (IR-2019-101). Further, as of June 28, 2020, transcripts will no longer be mailed to third parties. This policy covers all taxpayers, both individuals and businesses.

Instead, taxpayers will be able to obtain their own transcripts in one of four ways:

1. Access Get Transcript Online via **www.irs.gov** or the IRS2Go app.
2. Access Get Transcript by Mail via **www.irs.gov** or the IRS2Go app.
3. Call 800-908-9946 for the automated Get Transcript by Mail.
4. Submit Form 4506-T, Request for Transcript of Tax Return, to have the transcript mailed to the taxpayer's address of record.

Practitioners may not receive transcripts by mail but may obtain them via the e-services' Transcript Delivery System (TDS). These transcripts will have all personally identifiable information redacted.

OBSERVATION: The IRS has recently announced that transcripts will only be available to a practitioner for a limited time. Once the transcript has been viewed, it will be removed after three days. Additionally, the practitioner has only 30 days to view the transcript, as it will be removed after 30 days regardless of whether the transcript has been viewed. Once the transcript is opened, it should be printed and saved into the practitioner's filing system ASAP.

Other third-party vendors who require to verify income may obtain the information necessary by using the Income Verification Express Service (IVES). **Note:** The Taxpayer First Act has required an automated process of this service by 01/01/2023.

Due to the redaction of any personally identifiable information, a requester may assign a number such as Customer File Number, Loan Application Number, or some other number that allows the requester to identify the transcript.

WHAT THE IRS DOES WHEN IT RECEIVES A TAX RETURN

As practitioners, we focus on the client's file, looking for the receipt of Form 9325 (Acknowledgement and General Information for Taxpayers) after we hit the send button on a return. The question is, what happens to the return before it is "officially" accepted? The return goes through a series of "pre-posting" reviews to ensure that the information on the return is correct.

Pre-Posting Review Automated Processes

The IRS uses automated processes for some of these pre-posting reviews. If the IRS's automated pre-posting reviews do not identify any errors on the return, generally the return is processed. However, if one of the IRS's automated pre-posting reviews identifies an error on a return, then the return must be reviewed. There are four main reasons why a return may need to be reviewed:

1. Error resolution,
2. Rejected returns,
3. Unpostable returns, or
4. Suspected identity theft.

Error Resolution

Once errors on a return are identified, the IRS can:

1. Reject the error and manually release the taxpayer's refund; or
2. Confirm the error and notify the taxpayer that the IRS has used its "math error authority" to correct the error.

Under its math error authority, the IRS can summarily assess and collect tax without following the deficiency procedures (i.e., without first providing the taxpayer with a notice of deficiency), when correcting "mathematical and clerical" errors. [The definition of *mathematical and clerical errors* can be found in IRC Sec. 6213(g)(2).]

Rejected Returns

If the identified error on a return isn't an error that the IRS can use its math error authority to correct, then the return may be rejected. *Rejected returns* are usually missing some required part of a return, such as a schedule or a form, which the IRS needs to properly process the return. In this case, the IRS will typically send the taxpayer Letter 12C, Individual Return Incomplete for Processing. This letter gives the taxpayer 20 days to supply the IRS with the missing schedule or form. If the taxpayer doesn't respond within 20 days, the IRS will adjust the return (which usually results in a reduced refund or increased tax liability).

Unpostable Returns

Unpostable returns are usually paper returns that have errors so severe the IRS can't process them. The most common cause of unpostable tax returns is a mismatch between the taxpayer's identification number and name [i.e., the taxpayer's social security number doesn't match the name on file with the Social Security Administration (SSA)]. In this case, the IRS will send the taxpayer a letter informing them of the problem and instructing them to correct their name with the SSA.

Suspected Identity Theft

Before they are posted to the IRS's systems, returns are screened by the IRS's identity theft/fraud detection filters. If the IRS's identity theft/fraud detection filters select a return, then the return is sent to the Taxpayer Protection Program (TPP) for further scrutiny. The TPP will send the taxpayer a letter asking them to authenticate their identity either over the phone, online, or by visiting a Taxpayer Assistance Center.

WHERE TO GO FOR MORE INFORMATION

- Quick Alerts at **www.irs.gov/tax-professionals/e-file-providers-partners/subscribe-to-quick-alerts**
- News and Events at **www.irs.gov/newsroom**
- Tax Pro News and Resources at **www.irs.gov/tax-professionals/tax-pro-news-and-resources**

CHAPTER 21: QUALIFIED OPPORTUNITY ZONES (QOZs)

Learning Objectives

Completion of this chapter will enable participants to—

- Identify the types of gains eligible for QOZ treatment.
- Identify the QOZ temporary and permanent deferral opportunities.

WHAT'S NEW

1. The IRS finalized Regulations in December 2019.

GAINS INVESTED IN A QUALIFIED OPPORTUNITY FUND DEFERRAL AND EXCLUSIONS

The TCJA authorizes the designation of certain low-income communities as *Qualified Opportunity Zones* (QOZs). The law provides for the temporary deferral of gains reinvested in a Qualified Opportunity Fund (QO Fund) and the permanent exclusion of certain capital gains from the sale or exchange of an investment if the investment is held for 10 years.

LAW CHANGE ALERT: Notice 2020-39 states that if a taxpayer's 180-day reinvestment period fell after March 31, 2020, but before December 31, 2020, the taxpayer had until December 31, 2020, to reinvest eligible gain in a qualified opportunity fund.

Eligible property will be the gains from the sale of capital assets. These gains will not be reduced by capital losses. The gain can be short-term or long-term gains. If an IRC provision requires a potential capital gain to be recharacterized as ordinary income, such ordinary gain cannot be eligible gain under the final regulations for deferral investment in a QOZ.

A gain distributed by a flow-through entity such as a partnership, trust or S corporation is eligible for deferral investment in a QOZ. It does not include grantor trusts as the assets of the trust are considered owned by the grantor.

Temporary Deferral

Gross income does not include capital gains reinvested in QO Funds within a 180-day period beginning with the date of the sale or exchange, if elected by a taxpayer. Although the Committee Reports indicate the deferral election applies to "capital gains" reinvested in a QO fund, IRC Sec. 1400Z-2(a) applies to gains from the sale or exchange of "any property" and isn't expressly limited to gains from the sale or exchange of a capital assets. The gains can come from a variety of sources including the sale of stock, collectibles, and Section 1231 gains. There is no deferral limit to the amount that can be deferred under the temporary deferral election other than the "net gain," previously noted.

The deferred income is included in income in the tax year which includes the earlier of—

1. The date on which the investment is sold or exchanged [IRC Sec. 1400Z-2(b)(1)(A)], or
2. December 31, 2026 [IRC Sec. 1400Z-2(b)(1)(B)].

The gain recognized is the lesser of the gain deferred or the FMV of the investment over the basis in the investment.

The original basis in the investment is “zero” since only the deferred gain is invested. However, if the investment is held for at least 5 years, the basis in the investment is increased by an amount equal to 10% of the gain temporarily deferred. If the investment is held for at least 7 years, the basis in the investment is increased by an additional 5% of the gain.

Permanent Exclusion

Under the permanent exclusion, any post-acquisition capital gains on investments in a QO Fund held for at least 10 years are excluded from gross income. Accordingly, while the deferred gain must be recognized by 12/31/2026, the appreciation on the investment escapes taxation if held for at least 10 years.

How to Report the Deferred Gain

Report the full amount of capital gain on Form 8949 (Sales and other Dispositions of Capital Assets) as if no QO fund election was made. Then report the deferral of the eligible gain on Form 8949 by entering on its own row the following items: “QO Fund” and the name and taxpayer ID number of the fund in column (a); the date the fund was acquired in column (b); code Z in column (f); and the amount of the deferred gain as a negative number (in parentheses) in column (g). This Form 8949 is attached to the tax return for the year in which the gain would have been recognized but for the election to invest in a QO Fund.

EXAMPLE: Reporting deferred gain from QO fund investment

Brian sells property and realizes a gain of $1 million on 1/2/2020. On 12/31/2020 (within 180-day period beginning on 1/2/2020 as extended by Notice 2020-39), Brian invests the entire $1 million gain in a QO Fund. Brian does not include the $1 million of realized gain on his 2020 tax return.

If Brian does not sell the investment until 12/31/2027, his basis in the investment will increase by $100,000 (5-year holding period, so 10% of the deferred gain) plus any gain recognized on 12/31/2026. As Brian does not sell or exchange the investment before 12/31/2026, he will recognize a gain on the lesser of the FMV over his basis ($100,000) or the unrealized remaining deferred gain at that time ($900,000).

If Brian continues to hold the investment for a 10-year period, the basis in the investments in QO funds would be $100,000 (basis increase) plus gain recognized in 2026. In 2030 Brian’s basis will be $1 million. Assume in 2030 Brian sells his QO Fund investment for $1.2 million. The $200,000 long-term gain is permanently excluded from Federal income taxation.

Determining Start of 180-Day Period of QOZ Investment Gain Event

GAIN EVENT	180-DAY PERIOD
Capital gain (general)	• Starts on day gain would be otherwise recognized for Federal income tax purposes
Flow-through entity gain (e.g., partnership)	• General – Last day of the partnership taxable year • Optional – Same as the partnership's 180-day period • Optional – Starts on due date of entity's tax return, not including extensions
RIC and REIT gains	• General rule – starts at close of shareholder's tax year • Optional – Starts when shareholder receives capital gain dividends from a RIC or a REIT
Installment sales	• Starts when installment sale proceeds are received
Inclusion event (e.g., gift)	• Starts on the date of the inclusion event

UNDERSTANDING QO ZONE DEFINITIONS AND ALLOWED INVESTMENTS

1. **QO Zone.** A *QO zone* is a population census tract that is a low-income community. IRS must certify and designate the community as a QO zone [IRC Sec. 1400Z-1(a)]. The term low-income community is borrowed from the Section 45D new markets tax credit [IRC Sec. 1400Z-1(c)(1)]. These zones were identified by state governors. QO zone eligible tracks include:

    a. Any population census tract with a poverty rate of at least 20%.

    b. A tract whose median family income does not exceed 80% of statewide median family income. Note: For tracts located within a metropolitan area, the standard is 80% of the greater of—

        i. statewide median family income or

        ii. the metropolitan area median family income.

PLANNING TIP: Notice 2018-48 lists the census tracts that the Secretary of the Treasury designated as QO zones. Additional information can be obtained at the US Department of Treasury Community Development Financial Institutions Fund at **www.cdfifund.gov/Pages/Opportunity-Zones.aspx**.

2. **Qualified Opportunity Fund (QOF).** IRC 1400Z-2 defines a *qualified opportunity fund* as any investment vehicle which is organized as a corporation or a partnership that holds at least 90% of its assets in qualified opportunity zone property. If the entity has an applicable financial statement as defined in Reg, 1,475(a)-(h), the analysis is based on the value of each asset owned or leased by the QOF. Otherwise, the valuation is done using unadjusted cost basis. The date pursuant to Notice 2020-39 has been extended to meet the 90% rule until 12/31/2020.

3. **Qualified Opportunity Fund Self-Certification.** The regulations provide for a self-certification of a QO Fund. The certification is to be done in a form and manner as prescribed by IRS. The certification must identify the first taxable year the eligible entity wants to be a QOF. The entity may also identify the first month the entity wants to be treated as a QO Fund. Per IRS Q&A, the self-certification is done by filing Form 8996, Qualified Opportunity Fund, with its federal income tax return.

NOTE: While 90% of the QOF assets must be in the QO Zone, businesses owned by the funds have several tests to meet the substantially all requirements.

4. **QO Zone Property.** *QO zone property* includes the following [IRC Sec. 1400Z-2(d)(2)]:

   a. *QO Zone Stock.* This is stock acquired by the QO fund after 2017, at its original issue from a domestic corporation solely for cash. At the time the stock is issued, substantially all the tangible property owned or leased by the corporation must be QO zone business property (among other requirements). The corporation must satisfy these requirements during substantially all the QO fund's holding period in the stock.

   b. *QO Zone Partnership Interests.* These are capital or profits interests issued by a domestic partnership for cash after 2017. The QO zone stock requirements explained earlier also apply to QO zone partnership interests.

   c. *QO Zone Business Property.* This is tangible property used in a trade or business if—

      i. the property is purchased by the QO fund after December 31, 2017,

      ii. the original use of the property in the QO zone starts with the QO fund (or the QO fund substantially improves the property), and

      iii. during substantially all the QO fund's holding period in the property, substantially all the use of the property is in a QO zone.

OBSERVATION: While debt investment does not qualify as QO Zone property, preferred ownership or preferred stock does. Accordingly, it is expected that potential lenders will consider taking preferred stock positions because of the associated benefits.

5. **Substantially Improves.** What does "substantially improves" the property mean?

   a. Except for the special rule for land and improvements on land, tangible property is treated as substantially improved if during any 30-month period beginning with the date of acquisition of the property, additions to the property exceed an amount equal to the basis of the property at the beginning of the period.

b. For buildings, substantial is measured by the adjusted basis of the building only. The QOF is not required to substantially improve the land upon which the building is located. Note: Treasury has indicated that if a building has been vacant for 5 years there is no substantially improvement requirement because it is considered original use property.

In general, a trade or business of an entity is treated as satisfying the substantially all requirement if at least 70 percent of the tangible property owned or leased by the trade or business is qualified opportunity zone business property.

Not all trades and businesses qualify, these are referred to as sin businesses in the final regulations. Pursuant to section 1400Z-2(d)(3)(A)(iii) the following do not qualify as a qualified opportunity zone business:

1. Any private or commercial golf course,
2. Country club,
3. Massage parlor,
4. Hot tub facility,
5. Suntan facility,
6. Racetrack or other facility used for gambling, or
7. Any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

QO ZONE OWNERSHIP TRANSFER ISSUES

The gift of an investment in a QOF would trigger the recognition of the deferred gain. This includes transfers to charities. There are exceptions for transfers for grantor trusts:

1. The death of the owner will not trigger the recognition of the deferred gain.
2. The distribution of a QOF interest to a beneficiary of the estate or revocable trust would not trigger recognition of the deferred gain.
3. The distribution of an interest in a QOF by an estate to a trust that was a grantor trust before the grantor's death, or from that trust to a beneficiary, also will not trigger recognition of the deferred gain.
4. An interest in a QOF held at the owner's death is treated as an item of income in respect of a decedent. Therefore, gain is recognized on a sale, exchange, or other disposition by the deceased taxpayer's estate or trust (other than a distribution to a beneficiary or heir).
5. The 5-, 7-, and 10-year holding periods in a QOF interest carryover to the recipient who receives the interest at the owner's death or by a gift to grantor trust.

QO ZONE ADVANTAGES AND CONCERNS

Given the complexity of the rules, most taxpayers are going to need an expert to guide them in this area. Accountants who aid taxpayers in setting up a QO fund should consider working closely with legal counsel.

The QO Zone benefits have been a boom for real estate developers looking to raise capital from investors. The developer can develop a new property and sell it to QO Zone investors or sell existing property to a QO Fund for later improvement. Those looking to sell property into QO Funds *cannot* maintain more than 20% of the fund.

Institutional players are just starting to move into this area. Most of qualifying prepackaged investments have considerable fees associated with them. Remember: to really make this work, the deal must be a good deal.

The QO Zone deferral can be used for any gain (e.g., sale of Apple stock, Grandmother's art collection, or business gains).

The sale of QO Zone asset gain can also apply for QO Zone treatment. Therefore, QO Zone gains qualify for other QO Zone investment deferrals.

A QO fund that fails the 90% test is subject to a penalty for each month of noncompliance [IRC Sec. 1400Z-2(f)]. The penalty amount is calculated under the following formula:

$$\begin{array}{c}\text{90\% of Aggregate Assets} \\ - \\ \text{Aggregate Amount of QO Zone Property}\end{array} \times \begin{array}{c}\text{Section 6621(a)(2) Underpayment} \\ \text{Rate for the Month}\end{array}$$

No penalty is imposed if the failure is due to reasonable cause [IRC Sec. 1400Z-2(f)(3)]. Note extension of time frame by Notice 2020-39.

While the permanent exclusion is an advantage, there is no guarantee the investment will earn a positive return. However, an investment held 10 years which generates federal-tax-free income is attractive.

The deferral exclusion does have a couple of concerns, however:

1. Even if the investment is not sold, the deferral gain must be recognized on December 31, 2026.
2. Further, there is no guarantee that future tax rates remain at present low levels.

Deferring the net gain only is attractive when compared to Section 1031 exchanges where the gross sale proceeds must be reinvested. Further, the deferral is not limited to exchanges of real estate as are post-TCJA Section 1031 exchanges. When dealing with real estate, Section 1031 exchanges have other advantages:

1. There is no mandatory income recognition as there is with the deferred exchange (December 31, 2026). However, you will pay tax on both the original gain and post exchange gains.
2. Section 1031 exchanges can be held for productive use such as investment property. The QO Zone deferral must be used in trade or business.

3. Section 1031 exchanges are not limited to investments in qualified zones.

4. The taxpayer controls when the replacement property is sold if ever. If the Section 1031 replacement property is held until death, there is no income with respect to the decedent and that taxpayer receives a step up of basis. [IRC Sec. 1014].

5. There is no need to make substantial improvements on the property in a Section 1031 exchange.

6. The definition of *like-kind* for real property exchanges is fairly broad. The regulations cite the following examples of like-kind properties: improved real property for unimproved real property, city real estate for a farm or ranch, and a leasehold having 30 or more years for a fee interest in real property. Thus, unimproved land can be exchanged for an apartment house.

SELECTIONS FROM THE IRS's QO ZONES Q&As

The IRS mostly provides guidance on QO Zones via Q&As. Currently, the list has grown to 51 Q&As and is difficult to work through. The following two selections were taken from the IRS's website at **www.irs.gov/newsroom/opportunity**. They are updated as a result of the final Regulations.

What Types of Gains May Be Invested and When?

1. *General rule*—The final regulations amend the proposed regulations' general rule that only capital gain may be invested in a Qualified Opportunity Fund (QOF) during the 180- day investment period by clarifying that only eligible gain taxable in the United States may be invested in a QOF

2. *Sales of business property*—The proposed Regulations only permitted the amount of an investor's gains from the sale of business property that were greater than the investor's losses from such sales to be invested in QOFs and required the 180-day investment period to begin on the last day of the investor's tax year. The final Regulations allow a taxpayer to invest the entire amount of gains from such sales without regard to losses and change the beginning of the investment period from the end of the year to the date of the sale of each asset.

3. *Partnership gain*—Partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and non-grantor trusts have the option to start the 180-day investment period on the due date of the entity's tax return, not including any extensions. This change addresses taxpayer concerns about potentially missing investment opportunities due to an owner of a business entity receiving a late Schedule K-1 (or other form) from the entity.

4. *Investment of Regulated Investment Company (RIC) and Real Estate Investment Trust (REIT) gains*—The rules clarify that the 180-day investment period generally starts at the close of the shareholder's tax year and provides that gains can, at the shareholder's option, also be invested based on the 180-day investment period starting when the shareholder receives capital gains dividends from a RIC or REIT.

5. *Installment sales*—The rules clarify that gains from installment sales are able to be invested when received, even if the initial installment payment was made before 2018.

6. *Nonresident investment*—The final Regulations provide that nonresident alien individuals and foreign corporations may make Opportunity Zone investments with capital gains that are effectively connected to a U.S. trade or business. This includes capital gains on real estate assets

taxed to nonresident alien individuals and foreign corporations under the Foreign Investment in Real Property Tax Act rules.

When May Gains Be Excluded from Tax after an Investment Is Held for a 10-year Period?

1. *Sales of property by a Qualified Opportunity Zone Business (QOZB)*—In the proposed Regulations, an investor could only elect to exclude gains from the sale of qualifying investments or property sold by a QOF operating in partnership or S Corporation form, but not property sold by a subsidiary entity. The final Regulations provide that capital gains from the sale of property by a QOZB that is held by such a QOF may also be excluded from income as long as the investor's qualifying investment in the QOF has been held for 10 years. However, the amount of gain from such a QOF's or its QOZBs' asset sales that an investor in the QOF may elect to exclude each year will reduce the amount of the investor's interest in the QOF that remains a qualifying investment.

2. *Applicability to other gains*—The final rules clarify that the exclusion is available to other gains, such as distributions by a corporation to shareholders or a partnership to a partner, that are treated as gains from the sale or exchange of property (other than inventory) for Federal income tax purposes.

CHAPTER 22: PLANNING FOR THE FUTURE—LATE CHANGES

Learning Objectives

Completion of this chapter will enable participants to—

- Advise clients on potential tax law changes.

INTRODUCTION

While planning for this course, the Gear Up Team was concerned about the timing of proposed legislation that could significantly impact individuals and small businesses. The provisions target higher-income individuals and corporations (both C and S), which are our target markets. As of August 20, 2021, the deliberations continue but the bills remained unpassed.

The best source for the potentially new tax law is the Biden Administration's Green Book issued on June 1, 2021. The plan contains detailed information about the administration's tax proposals for fiscal year 2022 included in both the American Jobs Plan and the American Families Plan.

> **NOTE:** The plans include significant changes outside our scope of tax law, including support for housing and infrastructure, prioritizing clean energy, and other social goals which we will not discuss. Our focus will be on the provisions impacting clients of small and medium tax professions. Finally, it is highly likely that many of the proposals discussed in this chapter will be modified or not acted on at all.

Corporate provisions include:

1. Raise the corporate income tax rate to 28%
2. Revise the global minimum tax regime, disallow deductions attributable to exempt income, and limit inversions
3. Reform taxation of foreign fossil fuel income
4. Repeal the deduction for Foreign-Derived Intangible Income (FDII)
5. Replace the Base Erosion Anti-Abuse Tax (BEAT) with the Stopping Harmful Inversions and Ending Low-Tax Developments (SHIELD) Rule
6. Limit foreign tax credits from sales of hybrid entities
7. Restrict deductions of excessive interest of members of financial reporting groups for disproportionate borrowing in the United States
8. Impose a 15% minimum tax on book earnings of large corporations
9. Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas

Individual Provisions include:

1. Increasing income tax rates for those with the highest incomes.
2. Eliminating the carried interest preference and the like-kind real estate preference for those with the highest incomes.
3. Taxing capital income for high-income earners at ordinary rates to the extent income exceeds $1 million.
4. Repeal deferral of gain from like-kind exchanges
5. Make permanent excess business loss limitation of noncorporate taxpayers.
6. Treating certain transfers of appreciated property by gift or on death as realization events.
7. More generous child tax credits, an expanded earned income tax credit, expanded child and dependent care tax credits, and more generous premium tax credits.
8. Eliminating all fossil fuel tax subsidies.
9. Expanding tax incentives that encourage clean energy sources, energy efficiency, carbon sequestration, and electric vehicle adoption.
10. Investments in taxpayer compliance that would provide the IRS with additional resources and information.

Provisions to Improve Tax Administration:

1. Increase oversight of paid tax return preparers
2. Enhance accuracy of tax information
3. Expand broker information reporting with respect to crypto assets
4. Address taxpayer noncompliance with listed transactions
5. Modify tax administration rules
6. Authorize limited sharing of business tax return information to measure the economy more accurately

PROPOSED INCREASE IN CORPORATE TAX RATE

Current Law

The Tax Cuts and Jobs Act of 2017 replaced a graduated tax schedule (with most corporate income taxed at a marginal and average rate of 35%) with a flat tax of 21% applied to all C corporations.

Reasons for Change

Raising the corporate income tax rate is an administratively simple way to raise revenue to pay for the administration's infrastructure proposals and other long-run drivers of spending growth. Furthermore, a corporate tax rate increase can increase the progressivity of the tax system and help reduce income inequality. Additionally, a significant share of the effects of the corporate tax increase would be borne by foreign investors. Therefore, some of the revenue raised by this proposal would result in no additional federal income tax burden to U.S. persons. Also, the majority of U.S. equity income is untaxed by the U.S. government at the individual level, so the corporate tax is a primary mechanism for taxing such capital income.

Proposal

The proposal would increase the income tax rate for C corporations from 21% to 28%. The proposal would be effective for taxable years beginning after December 31, 2021. For taxable years beginning after January 1, 2021, and before January 1, 2022, the tax rate would be equal to 21% plus 7% times the portion of the taxable year that occurs in 2022.

Reforms to global taxation include#the “global averaging” method for calculating a U.S. shareholder's global minimum tax would be replaced with a “jurisdiction-by-jurisdiction” calculation. Under the new standard, a U.S. shareholder's global minimum tax inclusion and, by extension, residual U.S. tax on such inclusion, would be determined separately for each foreign jurisdiction in which its CFCs have operations. As a result, a separate foreign tax credit limitation would be required for each foreign jurisdiction.

INCREASED TOP MARGINAL INCOME BRACKET PROPOSAL

Current Law

For taxable years beginning after December 31, 2017, and before January 1, 2026, the top marginal tax rate for the individual income tax is 37%. For taxable years beginning after December 31, 2025, the top marginal tax rate for the individual income tax is 39.6%.

For 2021, the 37% marginal individual income tax rate applies to taxable income over $628,300 for married individuals filing a joint return and surviving spouses, $523,600 for unmarried individuals (other than surviving spouses) and head of household filers, and $314,150 for married individuals filing a separate return.

Reason for Change

The proposal would reverse a recent tax cut for the highest income taxpayers. It would raise revenue while increasing the progressivity of the tax system.

Proposal

The proposal would increase the top marginal individual income tax rate to 39.6%. This rate would be applied to taxable income in excess of the 2017 top bracket threshold, adjusted for inflation. In taxable year 2022, the top marginal tax rate would apply to taxable income over $509,300 for married individuals filing a joint return, $452,700 for unmarried individuals (other than surviving spouses), $481,000 for head of household filers, and $254,650 for married individuals filing a separate return. After 2022, the thresholds would be indexed for inflation using the C-CPI-U, which is used for all current tax rate thresholds for the individual income tax.

Proposed Effective Date

The proposal would be effective for taxable years beginning after December 31, 2021.

NET INVESTMENT INCOME AND SELF-EMPLOYMENT CONTRIBUTIONS ACT TAXES PROPOSAL

Current Law

1. Individuals with Incomes Over a Threshold Amount Are Subject To A 3.8% Tax on Net Investment Income. The threshold is $200,000 for single and head of household returns and $250,000 for joint returns. Net investment income generally includes—

   a. Interest, dividends, rents, annuities, and royalties, other than such income derived in the ordinary course of a trade or business;

   b. Income derived from a trade or business in which the taxpayer does not materially participate;

   c. Income from a business of trading in financial instruments or commodities; and

   d. Net gain from the disposition of property other than property held in a trade or business in which the taxpayer materially participates. The net investment income tax (NIIT) does not apply to self-employment earnings. Proceeds from the NIIT flow into the General Fund of the Treasury.

2. Self-Employment Earnings and Wages Are Subject to Employment Taxes under Either the Self-Employment Contributions Act (SECA) or the Federal Insurance Contributions Act (FICA), Respectively. Both SECA and FICA taxes apply at a rate of 12.4% for social security tax on employment earnings (capped at $142,800 in 2021) and at a rate of 2.9% for Medicare tax on all employment earnings (not subject to a cap). An additional 0.9% Medicare tax is imposed on self-employment earnings and wages of high-income taxpayers, above the same NIIT thresholds of $200,000 for single and head of household filers and $250,000 for joint filers. The SECA and FICA taxes flow into the Social Security and Hospital Insurance Trust Funds.

3. General Partners and Sole Proprietors Pay SECA Tax on the Full Amount of Their Net Trade or Business Income, Subject to Certain Exceptions. IRC Sec. 1402(a)(13) provides that limited partners are statutorily excluded from paying SECA tax with respect to their distributive shares of partnership income or loss, although they are subject to SECA tax on their Section 707(c) guaranteed payments from the partnership that are for services they provide to, or on behalf of, the partnership. Because the statutory exclusion only refers to limited partners, questions have arisen as to the meaning of this term and whether the limited partner exclusion might be applicable to limited liability company (LLC) members. Some partners who might more accurately be considered general partners and some LLC members avoid SECA by claiming the treatment of limited partners.

4. S Corporation Shareholders Are Not Subject to SECA Tax. However, tax law requires that owner-employees pay themselves “reasonable compensation” for services provided, on which they pay FICA tax like any other employee. Nonwage distributions to shareholders of S corporations are not subject to either FICA or SECA taxes.

Reason for Change

1. Active owners of pass-through businesses are treated differently for purposes of the NIIT and SECA tax according to the legal form of their ownership and the legal form of the payment that

they receive. While general partners and sole proprietors pay SECA tax on earnings from their businesses, S corporation owner-employees and limited partners (their counterparts and sometimes competitors) pay employment taxes on only a portion of their earnings. LLC members often pay little or no SECA tax at all. Although the NIIT reflects an intention to impose the 3.8% tax on both earned and unearned income of high-income taxpayers, certain income escapes both SECA tax and the NIIT, including the distributive shares of S corporation shareholder-employees, limited partners, and LLC members who claim the statutory exclusion for limited partners. Different treatment is unfair, inefficient, distorts choice of organizational form, and provides tax planning opportunities for business owners, particularly those with high incomes, to avoid paying their fair share of taxes.

2. The current system is also a challenge for the Internal Revenue Service (IRS) to administer. The determination of "reasonable compensation" of S corporation owners generally depends on facts and circumstances and requires a valuation analysis, which is expensive, and which can be contested by the taxpayer, adding to the cost of administration and enforcement. Uncertainty surrounding the treatment of limited partners and LLC members who materially participate in their businesses undermines the IRS's ability to ensure payment of SECA tax and the NIIT.

3. In addition, proceeds from the NIIT are paid into the General Fund of the Treasury, while the Medicare portion of FICA and SECA taxes are paid into the Hospital Insurance Trust Fund. This treatment of the taxes is inconsistent with the fact that the taxes are intended for the same purpose.

Proposal

The proposal would (1) ensure that all pass-through business income of high-income taxpayers is subject to either the NIIT or SECA tax, (2) redirect NIIT funds to the Hospital Insurance Trust Fund, (3) make the application of SECA to partnership and LLC income more consistent for high-income taxpayers, and (4) apply SECA to the ordinary business income of high-income nonpassive S corporation owners.

1. The proposal would ensure that all trade or business income of high-income taxpayers is subject to the 3.8% Medicare tax, either through the NIIT or SECA tax. For taxpayers with adjusted gross income in excess of $400,000, the definition of net investment tax would be amended to include gross income and gain from any trades or businesses that is not otherwise subject to employment taxes.

2. All the revenue from the NIIT (that raised under current law and that which would be raised by the proposed expansion) would be directed to the Hospital Insurance Trust Fund, just as is the revenue from the 3.8% tax under FICA and SECA.

3. Limited partners and LLC members who provide services and materially participate in their partnerships and LLCs would be subject to SECA tax on their distributive shares of partnership or LLC income to the extent that this income exceeds certain threshold amounts. The exemptions from SECA tax provided under current law for certain types of partnership income (e.g., rents, dividends, capital gains, and certain retired partner income) would continue to apply to these types of income.

4. S corporation owners who materially participate in the trade or business would be subject to SECA taxes on their distributive shares of the business's income to the extent that this income exceeds certain threshold amounts. The exemptions from SECA tax provided under current law for certain types of S corporation income (e.g., rents, dividends, and capital gains) would continue to apply to these types of income.

5. In order to determine the amount of partnership income and S corporation income that would be subject to SECA tax under the proposal, the taxpayer would sum—

   a. ordinary business income derived from S corporations for which the owner materially participates in the trade or business, and

   b. ordinary business income derived from either limited partnership interests or interests in LLCs that are classified as partnerships to the extent a limited partner or LLC member materially participates in its partnership's or LLC's trade or business (this sum referred to as the “potential SECA income”).

6. Beginning in 2022, the additional income that would be subject to SECA tax would be the lesser of—

   a. the potential SECA income, and

   b. the excess over $400,000 of the sum of the potential SECA income, wage income subject to FICA under current law, and 92.35% of self-employment income subject to SECA tax under current law. The $400,000 threshold amount would not be indexed for inflation.

7. Material participation standards would apply to individuals who participate in a business in which they have a direct or indirect ownership interest. Taxpayers are usually considered to materially participate in a business if they are involved in it in a regular, continuous, and substantial way. Often this means they work for the business for at least 500 hours per year. The statutory exception to SECA tax for limited partners would not exempt a limited partner from SECA tax if the limited partner otherwise materially participated.

Proposed Effective Date

The proposal would be effective for taxable years beginning after December 31, 2021

MODIFICATION OF THE CENTRALIZED PARTNERSHIP AUDIT REGIME

Current Law

IRC Sec. 6226 requires reviewed year partners to include in their reporting year taxes an amount equal to the change in tax that would have occurred for the reviewed year and all years between the reviewed year and the reporting year if the partnership adjustments were taken into account by the partners in those taxable years. The statutory formula provides, however, that for each of those years, the partners take into account the changes in tax liability that would have occurred in those years by increasing or decreasing their tax liability on their reporting year return by the sum of those changes in tax. If the calculation results in a net decrease, current law treats that net decrease as an amount that can be used by the partners to reduce their reporting year income tax liabilities to zero. Any excess of that amount not offset with an income tax due in the reporting year at the partner level does not result in an overpayment that can be refunded. The excess amount cannot be carried forward and is permanently lost.

Requisite Supervisory Approval of Penalty Included in Notice

IRC Sec. 6751(b)(1) provides that no penalty under Title 26 shall be assessed unless the initial determination of such assessment is personally approved in writing by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary of the Treasury or her delegate may designate. This section applies to all civil penalties imposed by the Code, except for penalties under IRC Sec. 6651 for failure to file tax returns or to pay tax; IRC Sec. 6654 for failure by individuals to pay estimated income tax; IRC Sec. 6655 for failure by corporations to pay estimated income tax; IRC Sec. 6662 with respect to an overstatement of certain qualified charitable contributions; and penalties that are automatically calculated through electronic means. With respect to individuals, the Internal Revenue Service (IRS) has the burden of production in a United States Tax Court proceeding challenging penalties to show the penalties are appropriate.

Reasons for Change

1. The inability for reviewed year partners to receive the full benefit of any reductions in tax as a result of partnership adjustments can lead to situations where a partner may be viewed as being taxed more for an adjustment made under the centralized partnership audit regime than the partner would have outside of the centralized partnership audit regime.

2. With respect to obtaining supervisory approval pursuant to IRC Sec. 6751(b), recent court decisions have led to uncertainty concerning, among other things, the requisite timing of the approval and qualified approvers. Judicial opinions have required supervisory approval of a penalty before the penalty is communicated to a taxpayer when a taxpayer still has the opportunity to raise defenses to the penalty. As a result, a supervisor may not have all the information relevant to making a decision whether a penalty is appropriate by the deadline certain opinions have imposed. Many judicial opinions have barred penalties that a supervisor approved before assessment and before any opportunity for judicial review. When supervisory approval did not meet judicially-created deadlines, courts have barred penalties without considering whether the penalties were appropriate under the facts of the particular case. These barred penalties have included accuracy-related penalties where the taxpayers did not show they acted with reasonable care for underpayments on their returns. Barred penalties have also included those arising from understatements attributable to reportable transactions that the IRS identified as tax avoidance transactions or that taxpayers entered into with a significant purpose of income tax avoidance or evasion. In some cases, barred penalties have even included civil fraud penalties where the IRS has met its burden of showing by clear and convincing evidence that an underpayment of tax was attributable to fraud. These cases undercut the purpose of penalties to deter taxpayer non-compliance with tax laws, based on unclear, hard to apply rules that often apply retroactively.

Proposal

1. Amend the centralized partnership audit regime to address tax decreases greater than a partner's income tax liability. The proposal would amend IRC Sec(s). 6226 and 6401 to provide that the amount of the net negative change in tax that exceeds the income tax liability of a partner in the reporting year is considered an overpayment under IRC Sec. 6401 and may be refunded.

2. Modify requisite supervisory approval of penalty included in notice- The proposal also clarifies that a penalty can be approved at any time prior to the issuance of a notice from which the Tax Court can review the proposed penalty and, if the taxpayer petitions the court, the IRS may raise a penalty in the court if there is supervisory approval before doing so. For any penalty not subject to Tax Court review prior to assessment, supervisory approval may occur at any time before assessment. In addition, this proposal expands approval authority from an "immediate supervisor" to any supervisory official, including those that are at higher levels in the management structure or others responsible for review of a potential penalty. Finally, this proposal eliminates the written approval requirement under IRC Sec. 6662 for underpayments of tax; IRC Sec. 6662A for understatements with respect to reportable transactions; and IRC Sec. 6663 for fraud penalties.

Proposed Effective Date

The proposals would be effective upon enactment1#

TAX CARRIED (PROFITS) INTERESTS AS ORDINARY INCOME

Current Law

A partnership is not subject to Federal income tax. Instead, an item of income or loss of the partnership retains its character and flows through to the partners who must include such item on their tax returns. Generally, certain partners receive partnership interests in exchange for contributions of cash and/or property, while certain partners (not necessarily other partners) receive partnership interests, typically interests in future partnership profits referred to as “profits interests” or “carried interests,” in exchange for services. Accordingly, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, will reflect their shares of such gain on their tax returns as long-term capital gain. If the partner is an individual, such gain would be taxed at the reduced rates for long-term capital gains. Gain recognized on the sale of a partnership interest, whether it was received in exchange for property, cash, or services, is generally capital gain. IRC Sec. 1061 generally extends the long-term holding period requirement for certain capital gains resulting from partnership property dispositions and from partnership interest sales, from one year to three years.

Under current law, income attributable to a profits interest is generally subject to self-employment tax, except to the extent the partnership generates types of income that are excluded from self-employment taxes (e.g., capital gains, certain interest, and dividends). A limited partner's distributive share is generally excluded from self-employment tax under IRC Sec. 1402(a)(13).

Reasons for Change

Although profits interests are structured as partnership interests, the income allocable to such interests is received in connection with the performance of services. A service provider's share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services. By allowing service partners to receive capital gains treatment on labor income without limit, even with the holding period extension provided by IRC Sec. 1061, the current system creates an unfair and inefficient tax preference. Activity among large private equity firms and investment funds has increased the breadth and cost of this tax preference, with some of the highest-income Americans benefiting from this preferential tax treatment.

Proposal

The proposal would generally tax as ordinary income a partner's share of income on an “investment services partnership interest” (ISPI) in an investment partnership, regardless of the character of the income at the partnership level, if the partner's taxable income (from all sources) exceeds $400,000. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains. In addition, the proposal would require partners in such investment partnerships to pay self-employment taxes on such income. In order to prevent income derived from labor services from avoiding taxation at ordinary income rates, this proposal assumes that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain, if the partner is above the income threshold. To ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

An ISPI is a profits interest in an investment partnership that is held by a person who provides services to the partnership. A partnership is an investment partnership if substantially all its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business. To the extent—

1. the partner who holds an ISPI contributes "invested capital" (which is generally money or other property) to the partnership, and
2. such partner's invested capital is a qualified capital interest (which generally requires that—
   a. the partnership allocations to the invested capital be made in the same manner as allocations to other capital interests held by partners who do not hold an ISPI and
   b. the allocations to these non-ISPI holders are significant), income attributable to the invested capital would not be recharacterized.

Similarly, the portion of any gain recognized on the sale of an ISPI that is attributable to the invested capital would be treated as capital gain. However, "invested capital" will not include contributed capital that is attributable to the proceeds of any loan or advance made or guaranteed by any partner or the partnership (or any person related to such persons).

Also, any person who performs services for any entity and holds a "disqualified interest" in the entity is subject to tax at rates applicable to ordinary income on any income or gain received with respect to the interest, if the person's taxable income (from all sources) exceeds $400,000. A "disqualified interest" is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation). This is an anti-abuse rule designed to prevent the avoidance of the property through the use of compensatory arrangements other than partnership interests. Other anti-abuse rules may be necessary.

The proposal is not intended to adversely affect qualification of a real estate investment trust owning a profits interest in a real estate partnership.

Proposed Effective Date

The proposal would repeal IRC Sec. 1061 for taxpayers with taxable income (from all sources) in excess of $400,000 and would be effective for taxable years beginning after December 31, 2021.

REPEAL DEFERRAL OF GAIN FROM LIKE-KIND EXCHANGES

Current Law

Currently, owners of appreciated real property used in a trade or business or held for investment can defer gain on the exchange of the property for real property of a "like kind." As a result, the tax on the gain is deferred until a later recognition event, provided that certain requirements are met.

Reasons for Change

The proposal would treat the exchanges of real property used in a trade or business (or held for investment) similarly to sales of real property, resulting in fewer distortions. The change would raise revenue while increasing the progressivity of the tax system.

Proposal

The proposal would allow the deferral of gain up to an aggregate amount of $500,000 for each taxpayer ($1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like kind. Any gains from like-kind exchanges in excess of $500,000 (or $1 million in the case of married individuals filing a joint return) during a taxable year would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange.

Proposed Effective Date

The proposal would be effective for exchanges completed in taxable years beginning after December 31, 2021.

MAKE EXCESS BUSINESS LOSS LIMITATION OF NONCORPORATE TAXPAYERS PERMANENT

Current Law

IRC Sec. 461(l) limits the extent to which pass-through business losses may be used to offset other income. In particular, for taxable years beginning after December 31, 2020, and before January 1, 2027, noncorporate taxpayers may not deduct an “excess business loss” from taxable income. Instead, these losses are carried forward to subsequent taxable years as net operating losses.

Excess business loss is defined as the excess of losses from business activities over the sum of—

1. gains from business activities, and
2. a specified threshold amount.

In 2021, these thresholds are $524,000 for married couples filing jointly and $262,000 for all other taxpayers; these amounts are indexed for inflation thereafter. The determination of excess business loss is made at the taxpayer level, aggregating across all business activities. However, gains or losses attributable to any trade or business of performing services as an employee are not considered.

Reasons for Change

The proposal would bring the tax treatment of losses from nonpassive pass-through business activities closer in line with the tax treatment of losses from corporations and passive pass-through business activities.

Corporate losses do not flow through to individual owners. Instead, they are carried forward (or backward) to other taxable years to offset other income sources derived from the same business.

Losses from passive pass-through business activities face somewhat less restrictive constraints. They may generally only be used to offset income derived from other passive pass-through business activities. Generally, they may not offset other income sources, such as wage income.

By constraining individuals' abilities to offset income sources such as wages with nonpassive pass-through business losses, IRC Sec. 461(l) creates a more similar tax regime for business losses across different forms of business organization and types of business activity. However, the provision is set to expire in 2027.

Proposal

The proposal would make permanent the Section 461(l) excess business loss limitation on noncorporate taxpayers.

Proposed Effective Date

The proposal would be effective for taxable years beginning after December 31, 2026.

CHILD TAX CREDIT EXPANSION PROPOSAL

Current Law

Under IRC Sec. 24, a taxpayer may claim a child tax credit (CTC) for each qualifying child. The CTC was substantially expanded for tax year 2021 by the American Rescue Plan of 2021 (ARPA or ARP Act, PL 117-2). Prior expansions under the Tax Cuts and Jobs Act of 2017 (TCJA, PL 115-97) still apply for tax years 2021–2025. For subsequent tax years, most elements of the child credit reflect pre-TCJA law.

CTC in Tax Year 2021 (ARP in Effect)

Taxpayers may claim a CTC for up to $3,600 for each qualifying child under age 6 and up to $3,000 for all other qualifying children under age 18. The full amount of the credit is refundable, regardless of the taxpayer's Federal income tax liability or the presence of earned income.

For tax year 2021 only, taxpayers may receive up to 50% of their estimated total CTC (including ACTC) in advance, in a series of periodic payments ("50% rule"). These payments will be issued from July to December of 2021. A taxpayer may receive up to 50% of the credit computed based on information reported on their 2020 individual income tax return (or the 2019 return if the 2020 return is not available).

CTC for Tax Years 2022–2025 (TCJA in Effect, ARP Changes Expired)

For tax years 2022–2025, a taxpayer may claim a CTC of up to $2,000 per qualifying child, only part of which is refundable.

Reasons for Change

The Green Book explains that the ARP expansion of the CTC will substantially reduce child poverty by supplementing the earnings of families receiving the tax credit, making the full credit available to a significant number of new families with limited earnings and income tax liability (through complete refundability), and providing regular financial assistance to families throughout the year.

Green Book Proposal

The Green Book proposal would extend to tax years beginning before January 1, 2026, most of the ARP changes to the CTC including:

1. The term *qualifying child* would include a child who is 17 years old or younger.

2. Increasing the maximum tax credit per child to $3,600 for qualifying children under 6 and to $3,000 for all other qualifying children. The portion of the credit in excess of $2,000 would phase out when a taxpayer's income is in excess of $150,000 of modified AGI for married joint filers or surviving spouses, $112,500 for head of household filers, and $75,000 for all other filers, with a modified rule for large families.

3. The 50% rule: up to 50% in periodic payments.

4. The CTC would be made fully refundable, regardless of earned income, for all tax years.

5. Advance payments of the CTC would be automatically deposited by electronic funds transfer into the recipient's bank or card account each month.

The IRS will develop strategies to minimize the number of advance CTC payments that are paid to individuals who are ultimately not eligible for the credit. This effort will include additional statutory recommendations, regulatory changes, data collection, and data matching.

Proposed Effective Date

The proposal would be effective for tax years beginning after December 31, 2021 and beginning before January 1, 2026.

PROPOSED REFORMATION OF CAPITAL GAINS AND TRANSFER AT DEATH RULES

Current Law

Long-term capital gains and qualified dividends are taxed at graduated rates under the individual income tax, with 20% generally being the highest rate (23.8% including the net investment income tax, if applicable, based on the taxpayer's modified adjusted gross income).

Moreover, capital gains are taxable only upon realization, such as the sale or other disposition of an appreciated asset. When a donor gives an appreciated asset to a donee during the donor's life, the donee's basis in the asset is the basis of the donor; in effect, the basis is "carried over" from the donor to the donee. There is no realization of capital gain by the donor at the time of the gift, and there is no recognition of capital gain (or loss) by the donee until the donee later disposes of that asset.

When an appreciated asset is held by a decedent at death, the basis of the asset for the decedent's heir is adjusted (usually "stepped up") to the fair market value of the asset at the date of the decedent's death. As a result, any appreciation accruing during the decedent's life on assets that are still held by the decedent at death avoids federal income tax.

Reasons for Change

Preferential tax rates on long-term capital gains and qualified dividends disproportionately benefit high-income taxpayers and provide many high-income taxpayers with a lower tax rate than many low- and middle-income taxpayers. The rate disparity between ordinary income taxes and capital gains and dividends taxes also encourages economically wasteful efforts to convert labor income into capital income as a tax avoidance strategy.

Under current law, a person who inherits an appreciated asset receives a basis in that asset equal to the asset's fair market value at the time of the decedent's death; thus, appreciation that accrued during the decedent's life is never subjected to income tax. In contrast, less-wealthy individuals who must spend down their assets during retirement pay income tax on their realized capital gains. This increases the inequity in the tax treatment of capital gains. In addition, the preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.

Moreover, the distribution of wealth among Americans has grown increasingly unequal, concentrating economic resources among a steadily shrinking percentage of individuals. Coinciding with this period of growing inequality, the long-term fiscal shortfall of the U.S. has significantly increased. Reforms to the taxation of capital gains and qualified dividends will reduce economic disparities among Americans and raise needed revenue.

Proposal

1. Tax capital income for high-income earners at ordinary rates:

    > Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than $1 million would be taxed at ordinary income tax rates, with 37% generally being the highest rate (40.8% including the net investment income tax), but only to the extent that the taxpayer's income exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2022.

    This proposal would be effective for gains required to be recognized after "the date of announcement." Which according to our reading could be April of 2021.

2. Treat transfers of appreciated property by gift or on death as realization events. Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer. (Also see $1 million exception later in this chapter).

    a. For a donor, the amount of the gain realized would be the excess of the asset's fair market value on the date of the gift over the donor's basis in that asset.

    b. For a decedent, the amount of gain would be the excess of the asset's fair market value on the decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the decedent on "the Federal gift or estate tax return or on a separate capital gains return."

3. A transfer would be defined under the gift and estate tax provisions and would be valued using the methodologies used for gift or estate tax purposes. However, for purposes of the imposition of this tax on appreciated assets, the following would apply:

    a. First, a transferred partial interest would be its proportional share of the fair market value of the entire property.

    b. Second, transfers of property into, and distributions in kind from, a trust, partnership, or other non-corporate entity, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events.

4. The deemed owner of a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner

or the U.S. spouse of the deemed owner, other than a distribution made in discharge of an obligation of the deemed owner. All the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

5. 90-year rule. Gain on unrealized appreciation also would be recognized by a trust, partnership, or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030.

Certain exclusions would apply:

1. Transfers to charity. Transfers by a decedent to a U.S. spouse or to charity would carry over the basis of the decedent. Capital gain would not be recognized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would not generate a taxable capital gain. The transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes.

2. Tangible property and principal residence. The proposal would exclude from recognition any gain on tangible personal property such as household furnishings and personal effects (excluding collectibles). The $250,000 per-person exclusion under current law for capital gain on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively $500,000 per couple.

3. Small business stock. The exclusion under current law for capital gain on certain small business stock under IRC Sec. 1202 would also apply.

4. New $1 million exclusion. In addition to the above exclusions, the proposal would allow a $1 million per-person exclusion from recognition of other unrealized capital gains on property transferred by gift or held at death.

    a. The per-person exclusion would be indexed for inflation after 2022 and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively $2 million per married couple).

5. The recipient's basis in property received by reason of the decedent's death would be the property's fair market value at the decedent's death. The same basis rule would apply to the donee of gifted property to the extent the unrealized gain on that property at the time of the gift was not shielded from being a recognition event by the donor's $1 million exclusion. However, the donee's basis in property received by gift during the donor's life would be the donor's basis in that property at the time of the gift to the extent that the unrealized gain on that property counted against the donor's $1 million exclusion from recognition.

6. Family owned and operated businesses. Payment of tax on the appreciation of certain family-owned and operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated.

7. 15-year payment plan. The proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial

assets and other than businesses for which the deferral election is made. The IRS would be authorized to require security at any time when there is a reasonable need for security to continue this deferral. That security may be provided from any person, and in any form, deemed acceptable by the IRS.

a. To facilitate the transition to taxing gains at gift, death and periodically under this proposal, the IRS would be granted authority to issue any regs necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable, and reporting requirements for all transfers of appreciated property including value and basis information.

Proposed Effective Date

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2021, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2022.

IRS AND RELATED COMPLIANCE PROPOSALS

The Green Book proposals to increase IRS funding includes a proposed multi-year adjustment to discretionary spending allocation of IRS Enforcement and Operations Support of $6.7 billion and an additional $72.5 billion in mandatory funding.

Other proposals in compliance include:

1. Comprehensive Business Reporting. Because of limited information reporting on business income (Forms 1099-MISC, -NEC, and -K). the proposal would create a comprehensive financial account information reporting regime. The annual return will report gross inflows and outflows with a breakdown of physical cash, transactions with foreign account and transfers between owner accounts.

2. Increased Oversite of Paid Preparers.

   a. *IRS Can Regulate Preparers.* The proposal gives Secretary of Treasury the explicit authority to regulate all paid preparers of all federal tax returns and establish mandatory minimum competency standards. This would be effective on the date of enactment.

   b. *Penalties on Ghost Preparers.* Tax preparers who fail to identify themselves are ghost preparers. Current penalty for failure to identify is $50 per return not to exceed $25,000 per year. The proposal would increase the penalty amount to the greater of $500 per return or 100% of the income derived by a ghost preparer. Effective tor returns required to be filed after December 31, 2021.

3. Expanded Authority to Required Electronic Filing for Forms and Returns.

   a. Electronic filing would be required for returns filed by taxpayers reporting larger amounts or that are complex business entities, including—

      i. income tax returns of individuals with gross income of $400,000 or more;

   ii. income, estate, or gift tax returns of all related individuals, estates, and trusts with assets or gross income of $400,000 or more in any of the three preceding years;

   iii. partnership returns for partnerships with assets or any item of income of more than $10 million in any of the three preceding years;

   iv. partnership returns for partnerships with more than 10 partners;

   v. returns of REITs, REMICs, RICs, and all insurance companies; and

   vi. corporate returns for corporations with $10 million or more in assets or more than 10 shareholders.

b. Further, electronic filing would be required for the following forms:

   i. Form 8918, Material Advisor Disclosure Statement,

   ii. Form 8886, Reportable Transaction Disclosure Statement,

   iii. Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons,

   iv. Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds, and

   v. Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business.

c. Return preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file such returns electronically.

d. The Secretary would also be authorized to determine which additional returns, statements, and other documents must be filed in electronic form to ensure the efficient administration of the internal revenue laws without regard to the number of returns that a person files during a year.

4. <u>Improve Information Reporting for Reportable Payments Subject to Backup Withholding.</u> The proposal would also treat all information returns subject to backup withholding similarly. Specifically, the IRS would be permitted to require payees of any reportable payments to furnish their TINs to payors under penalty of perjury. The proposal would be effective for payments made after December 31, 2021.

5. <u>Crypto Currency.</u> The proposal would expand the scope of information reporting by brokers who report on crypto assets to include reporting on certain beneficial owners of entities holding accounts with the broker. This would allow the United States to share such information on an automatic basis with appropriate partner jurisdictions to reciprocally receive information on U.S. taxpayers that directly or through passive entities engage in crypto asset transactions outside the United States pursuant to a global automatic exchange of information framework.

a. The proposal would require brokers, including entities such as U.S. crypto asset exchanges and hosted wallet providers, to report information relating to certain passive entities and their substantial foreign owners when reporting with respect to crypto assets held by those entities in an account with the broker. The proposal, if adopted, and combined with existing law, would require a broker to report gross proceeds and such other information as the Secretary may require with respect to sales of crypto assets with respect to customers, and in the case of certain passive entities, their substantial foreign owners.

b. The proposal would be effective for returns required to be filed after December 31, 2022.

6. Taxpayer Noncompliance with Listed Transactions.

   a. *Extend Statute of Limitations for Listed Transactions.* The proposal would increase the limitations period under IRC Sec. 6501(a) for returns reporting benefits from listed transactions from three years to six years. The proposal also would increase the limitations period for listed transactions under IRC Sec. 6501(c)(10) from one year to three years. This proposed change would be effective on the date of enactment.

   b. *Impose Liability on Shareholders to Collect Unpaid Income Taxes of Applicable Corporations.* The proposal would also add a new section to the Code that would impose on shareholders who sell the stock of an "applicable C corporation" secondary liability (without resort to any State law) for payment of the applicable C corporation's income taxes, interest, additions to tax, and penalties to the extent of the sales proceeds received by the shareholders. The proposal applies to shareholders who, directly or indirectly, dispose of a controlling interest (at least 50%) in the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the applicable C corporation stock. The secondary liability would arise only after the applicable C corporation was assessed income taxes, interest, additions to tax, and penalties with respect to any taxable year within the 12-month period before or after the date that its stock was disposed of and the applicable C corporation did not pay such amounts within 180 days after assessment.

      i. For purposes of the proposal, an applicable C corporation is any C corporation (or successor) two thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or whose sale has been substantially negotiated on the date that a controlling interest in its stock is sold. The proposal would grant the Department of the Treasury authority to prescribe regulations necessary or appropriate to carry out the proposal. The proposal would not apply with respect to dispositions of a controlling interest (1) in the stock of a C corporation or real estate investment trust with shares traded on an established securities market in the United States, (2) in the shares of a regulated investment company that offers shares to the public, or (3) to an acquirer whose stock or securities are publicly traded on an established market in the United States, or is consolidated for financial reporting purposes with such a public issuer of stock or securities.

      ii. The proposal would close the taxable year of an applicable C corporation as of the later of a disposition of a controlling interest in its stock or a disposition of all of its assets. The proposal would also amend the Code to provide that the amount that the selling shareholder was secondarily liable for under this proposal would constitute a deficiency that was governed by the general notice and demand rules of the Code but with an additional year added to the statute of limitations for assessment. The proposal would not limit the government's ability to pursue any cause of action available under current law against any person.

iii. The proposed changes above would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2013.

7. Bureau of Economic Analysis (BEA). This proposal is to measure the economy more accurately by giving officers and employees of BEA access to Federal tax information (FTI) of those sole proprietorships with receipts greater than $250,000 and of all partnerships.

CHAPTER 23: SOLE PROPRIETOR—SCHEDULE C

Learning Objectives

Completion of this chapter will enable participants to—

- Determine whether a taxpayer's activity is a bona fide business under IRC Sec. 183.
- Identify the basics of reporting self-employment income and expenses.
- Apply the substantiation requirements under IRC Sec(s). 162 and 274.

WHAT'S NEW

The Consolidated Appropriations Act of 2021 increased the business-meal deduction for the cost of food and beverages provided by a restaurant from 50% to 100% in 2021 and 2022 if certain conditions are met. (See Chapter 24 for details.)

REPORTING PROFIT OR LOSS FROM BUSINESS (SCHEDULE C)

Schedule C is used to report income or loss from a business or profession operated as a sole proprietor. An activity qualifies as a business if the primary purpose for engaging in the activity is for income or profit and there is taxpayer involvement with continuity and regularity. A separate Schedule C must be completed for each business [Rev Rul. 81-90].

By default, a single-member LLC is treated as a disregarded entity for federal income tax purposes. A sole member of a domestic LLC reporting income or loss from a business or profession should file Schedule C or C-EZ unless they have elected to treat the domestic LLC as a corporation.

Schedule C is also used to report—

1. Wages and expenses incurred as a statutory employee.
2. Income and deductions of certain qualified joint ventures (QJVs).
3. Nonemployee compensation reported to the sole proprietor on Form 1099-NEC.
4. Certain income shown on Form 1099-MISC, Miscellaneous Income. This could include income earned from renting personal property as a business (Box 1), medical and health care payments (Box 6), etc.

Statutory Employees File Schedule C

A statutory employee receives a Form W-2 with the statutory employee box checked and is subject to withholding of Social Security and Medicare tax. The definition of a *statutory employee* is governed by IRC Sec. 3121(d)(3) which encompasses certain kinds of workers, such as agents or commissioned drivers distributing products, full-time life insurance salespersons, traveling or city salespersons, and home workers.

A statutory employee must provide the services personally, have no substantial investment in facilities used in connection with the work (other than vehicles) and have a continuing relationship with the employer. If the services are in the nature of a single transaction, not part of a continuing relationship with the person for whom the services are performed, a statutory employee relationship cannot exist [Reg. §31.3121(d)-1(d)(4)].

Qualified Joint Ventures (QJVs)

An unincorporated business activity that is properly classified as a spousal partnership for federal income tax purposes generally must comply with the partnership tax provisions, file an annual Form 1065, and issue annual Schedules K-1 to both spouses. Under an exception to the preceding general rule, eligible unincorporated spousal businesses are allowed to elect out of partnership tax status for federal income tax purposes, and thereby avoid the federal income tax compliance headaches associated with partnership status.

A *qualified joint venture* is an unincorporated business venture where:

1. The spouses are the only members.
2. The spouses own and operate the trade or business as co-owners (and not in the name of a state law entity such as an LLC or LLP).
3. Both spouses materially participate in the venture's business.
4. The spouses file a joint return and elect out of partnership tax status.

To be eligible for the election out, the spouses must file jointly, and the spousal business must be a qualified joint venture (QJV) [IRC Sec. 761(f)].

The election out is accomplished by the spouses separately reporting their respective shares of tax items from the QJV and separately reporting their shares of SE income (if any) from the QJV in the fashion explained earlier.

After electing out of partnership tax status, the spouses must separately report their respective shares of QJV tax items on the appropriate IRS forms. Spouses reporting income or loss from a business or profession should file separate Schedules C.

Similarly, the spouses must separately report their respective shares of QJV net SE income (if any) on separate Schedules SE. Each spouse then receives credit for his share of the SE income for Social Security benefit eligibility purposes [IRC Sec. 1402(a)(17)].

PLANNING TIP: If the spouses filed a Form 1065 for the year prior to the year for which the QJV election is made, the Form 1065 instructions state that they do not need to amend the prior-year return to make it a final return, nor do they need to file a final Form 1065 for the year the election is made. However, once made, the QJV election cannot be revoked without IRS consent.

There are special rules for unincorporated spousal businesses in community property states. In community property states, Rev. Proc. 2002-69 stipulates that the IRS will respect a married taxpayer's treatment of an unincorporated business as either a sole proprietorship or a spousal partnership.

The relief provisions offered by Rev. Proc. 2002-69 are limited to qualified business entities. A *qualified business entity* is one that meets all three of the following requirements:

1. It is wholly owned by spouses as community property under the laws of a state, foreign country, or U.S. possession,
2. No person other than the spouses would be considered an owner for federal tax purposes, and
3. It is not treated as a corporation under the check-the-box entity classification rules of Reg. §301.7701-2.

According to Rev. Proc. 2002-69, the rules explained previously apply "for federal tax purposes" which means they apply for federal SE tax purposes as well as for federal income tax purposes. Therefore, residents of community property states who own profitable qualified business entities should consider treating them as sole proprietorships when doing so would produce SE tax savings.

Trade or Business, or Hobby?

IRC Sec. 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A bona fide business must truly exist prior to claiming expenses under IRC Sec. 162. An expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on a trade or business, is commonly and frequently incurred in the type of business conducted by the taxpayer and is not a capital expenditure.

For the expenses to be deductible under IRC Sec. 162, the taxpayer must engage in or carry on an activity to which the expenses relate with an actual and honest objective of making a profit.

Taxpayers bear the burden of proving that they engaged in the activity with an actual and honest objective of realizing a profit.

Whether or not an activity is presumed to be operated for profit requires an analysis of the facts and circumstances of each case. There are nine non-exclusive factors contained in Reg. §1.183-2(b) to be used to evaluate an activity:

1. The manner in which the taxpayer carried on the activity,
2. The expertise of the taxpayer and his advisors,
3. The time and effort expended by the taxpayer in carrying on the activity,
4. Expectation that assets used in the activity may appreciate in value,
5. Success of the taxpayer in carrying on other similar or dissimilar activities,
6. The taxpayer's history of income or loss with respect to the activity,
7. The amount of occasional profits (if any) that are earned,
8. The financial status of the taxpayer, and
9. Elements of personal pleasure or recreation.

CAUTION: IRC Sec. 183 ATG lists several possible Section 183 activities, including fishing, farming, craft sales, dog breeding, gambling, direct sales (e.g., Amway, Pampered Chef, Tupperware), entertainers, horse racing, motocross racing, bowling, yacht charter, photography, airplane charter, horse breeding, auto racing, stamp collecting, artists, writing and rentals.

PLANNING TIP: The IRS Audit Technique Guide, IRC. Sec. 183: Activities Not Engaged in For Profit (ATG), offers a list of suggested interview questions for each of the above nine factors in Appendix B.

COURT CASES: In *Besten*, a pro se taxpayer, who both operated seed business and engaged in "cutting" horse activity, showed that the horse activity, which included breeding, raising, boarding, training, and selling registered cutting horses, qualified as for-profit activity under IRC Sec. 183. Notably, the horse activity was shown to be undertaken with requisite profit objective when considering overall factors, including facts that he had a business plan for activity, kept activity records consistent with his profit objective, changed and scaled down operations in attempt to accommodate economic realities, and actively marketed activity, which all told showed he operated same in businesslike manner; plus, he had expertise in and hired network of trainers to assist in horse operations, spent considerable time on activity, had success in other business, and didn't engage in activity solely for pleasure, but rather rode horses to train them and otherwise worked to prepare them for competition. The Tax Court found that the taxpayer wasn't in financial position to continue suffering activity losses without bona fide profit motive and concluded that his actions, coupled with sincere and credible testimony of business goals, overwhelmingly supported his claim of bona fide profit objective and outweighed countervailing factors regarding his loss history and lack of occasional profit during years at issue. (*Besten, Den v. Comm.*, TC Memo 2019-154)

In *Whatley*, the taxpayer (a successful banker), founded Sheepdog Farms LLC in 2004. While the tax return listed the principal activity as "farm" and principal product or service as "cattle" the farm did not have any cattle on the property until 2008 when the taxpayer was notified, he was under audit. In addition, the farming operations included maintenance of the property's timber which was not expected to be harvested until after 2021 with an expected future value of $332,000. During the years under audit (2004 – 2008) Sheepdog Farms reported $512,222 in net losses. The taxpayer spent about 700 hours a year on the farm but had no formal business plan. The taxpayer cited his family's expertise in running a large farm in which he participated at an early age and that at age 27 he began a timber-harvesting operation. The court found that eight of the nine factors to evaluate an activity as a hobby weighed against the taxpayer. With respect to the second factor, the taxpayer's expertise, the court noted that despite his family background on a farm, the taxpayer never operated a cattle farm and his previous experience had been over 35 years earlier and did not include growing trees. The court found the activity was not engaged in for profit and stated, "A cattle farm without cattle and a tree farm that doesn't yet harvest timber is highly likely to produce a bumper crop of losses." (*Whatley v. Comm.,* TC Memo 2021-11.

In *Gallegos,* the taxpayer who made a very good living from his insurance business decided to devote a very large chunk of his time to team roping. This cost him tens of thousands of dollars, some of which he put on the same Schedule C as his insurance business. While going through the nine-factor test in their opinion, the court relied heavily on the fact that team roping was a hobby for the taxpayer for nearly 20 years before the years at issue and led the court to find that the taxpayer derived a significant amount of personal pleasure from it. (*Joseph A. Gallegos, et ux. v. Comm.*, TC Memo 2021-25).

No single factor controls or other factors may be considered, and the mere fact that the number of factors indicating the lack of a profit objective exceeds the number indicating the presence of a profit objective (or vice versa) is not conclusive. For example, if five factors say the activity is not for profit, but four are on the profit side, the activity still could be determined to be engaged in for profit.

IRC Sec. 183(d) provides a presumption that an activity is engaged in for profit if the activity is profitable for three years of a consecutive five-year period or two years of a consecutive seven-year period for activities that consist of breeding, showing, training, or racing horses.

This presumption rule applies only after an activity incurs a third profitable (or second) profitable year within a five-year (or seven-year) presumption period that begins with the first profitable year.

EXAMPLE: Using the presumption rule to determine business status of an activity

Ali Bye has the following profits (losses) from the MLM sales activity.

- 2014: ($30,000)
- 2015: $5,000
- 2016: ($60,000)
- 2017: $2,000
- 2018: $5,000
- 2019: ($70,000)
- 2020: $3,000
- 2021: ($63,000)

The first five-year presumption period begins with the first profitable year of 2015, but the benefit of the presumption does not begin until the third profitable year of 2018. The presumption is not available for 2015 through 2017 because it does not apply until the third profitable year. The presumption is available during the first presumption period only in 2018 and 2019. The second five-year presumption period begins with the 2017 profitable year and runs through 2021. The presumption applies to the third profitable year of 2020 and will be of benefit for 2020 and 2021.

Even if the taxpayer meets the presumption rule, the IRS can still argue that the activity is not engaged in for profit; however, the burden of proof then shifts to the Service. In addition, examiners cannot use IRC Sec. 183(d) as the sole basis for disallowing losses under IRC Sec. 183 even if it is shown that the taxpayer has not met the presumption rule.

A taxpayer may elect to delay a determination as to whether the safe harbor applies until the close of the fourth (or sixth, in the case of horse racing, breeding, training, or showing) tax year after the tax year in which the taxpayer first engages in the activity. See Form 5213, Election to Postpone Determination as to Whether the Presumption Applies That an Activity Is Engaged in for Profit, for further information.

All income generated from hobby activities is reported as *other income* on Schedule 1 (Additional Income and Adjustments to Income) of Form 1040. Reg. §1.183-1(e) provides that gross income derived from an activity not engaged in for profit includes the total of all gains derived from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. Gross income may be determined from any activity by subtracting the cost of goods sold from the gross receipts as long as the taxpayer consistently does so and follows generally accepted methods of accounting in determining such income.

Expenses otherwise deductible under the hobby loss rules of IRC Sec. 183 are miscellaneous itemized deductions [Reg. §1.67-1T(a)(1)(iv)]. Taxpayers *may not* deduct miscellaneous itemized deductions in tax years 2018–2025.

COMPLETING SCHEDULE C

Line B, Business Code

The six-digit principal business code is used to identify the type of business. Choose this carefully; it should accurately reflect the nature of the business because it is used as part of the DIF (discriminate function system). DIF is a mathematical technique used by IRS to classify income tax returns for examination potential.

Line D, Employer Identification Number

Taxpayers are required to provide the nine-digit EIN only if the business has a qualified retirement plan, they are required to file employment, excise, alcohol, tobacco, or firearms returns, or are a payer of gambling winnings. If the EIN is not required, the taxpayer should leave line D blank. Do not enter the taxpayer's Social Security number.

PLANNING TIP: The sole owner of an LLC that is not treated as a separate entity for federal income tax purposes may have an EIN that was issued to the LLC (in the LLC's legal name) if the LLC is required to file employment tax returns and certain excise tax returns. Enter on Line D the EIN that was issued to the LLC (in the LLC's legal name). If the LLC does not have an EIN, leave line D blank.

Line F, Accounting Method

On January 5, 2021, the IRS released final Regulations providing guidance to implement several of the simplification provisions in the TCJA. For tax years beginning after December 31, 2017, taxpayers that have average annual gross receipts of $25 million or less ($26 million or less for both 2020 and 2021) during the preceding three years aren't required to account for the cost of goods sold using inventories under IRC Sec. 471 (and, thus, aren't required to use the accrual method of accounting), but rather may use a method of accounting for inventories that either—

1. treats inventories as non-incidental materials and supplies (NIMS inventory method); or

2. conforms to the taxpayer's financial accounting treatment of inventories.

Under the cash method, a taxpayer includes in gross income all items of income actually or constructively received during the tax year. The doctrine of constructive receipt requires a cash-basis taxpayer to recognize income when an item is credited to the taxpayer's account or made available without restriction [Reg. §1.451-2(a)].

Under the cash method, expenses are generally deductible in the tax year actually paid. However, the recent capitalization regulations clarify that both cash and accrual taxpayers generally must capitalize prepaid expenses [Reg. §1.263(a)-4(d)(3)]. Cash method taxpayers are not required to capitalize prepaid expenses that create a benefit that expires on or before the earlier of—

1. 12 months after the first day on which the taxpayer realizes the benefit of the expense, or

2. the end of the tax year after the year payment is made [Reg. §1.263(a)-4(f)(1)].

EXAMPLE: Expense treatment of prepaid lease

Professional Practice, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, the taxpayer prepays $240,000. No other amounts are due under the lease. The $240,000 is a prepaid expense and must be capitalized. The capitalized expense can be amortized over the period covered by the prepayment [Reg. §1.162-3(d)].

Line G, Material Participation

Material participation of the taxpayer must be indicated. If the taxpayer does not materially participate, the activity is passive, and the loss is limited by passive tax rules. However:

1. If the passive activity is profitable, self-employment tax applies.

2. If the passive activity is a loss, the loss for self-employment purposes is allowed in the same taxable year it is recognized under the passive loss rules [Temp. Reg. §1.469-1T(d)(3)].

NEW DEVELOPMENT: In CCA 202009024, the IRS determined that the basis loss limitation [IRC Sec. 704(d)] and the at-risk loss limitation (IRC Sec. 465) apply when determining a general partner's net earnings from self-employment for self-employment tax purposes. While the Chief Counsel Advice (CCA) considered the self-employment income taxation of a general partner, the guidance also applies to Schedule C taxpayers.

Participation in the activity by the spouse qualifies for purposes of determining material participation, even if the spouse did not own an interest in the business, and whether or not the taxpayers file a joint return.

Lines I and J, Payments of Fees and Other Non-Employee Compensation, Interest, Rents, Royalties, Real Estate Transactions, Annuities, and Pensions

If the taxpayer made any payments that require them to file any Form(s) 1099, check the "Yes" box. Otherwise, check the "No" box. Taxpayers may have to file information returns for certain payments of fees and other non-employee compensation, interest, rents, royalties, real estate transactions, annuities, and pensions.

A payer generally must report a payment in Box 1 of Form 1099-NEC if the following four conditions are met:

1. The payment is made to someone who is not an employee of the payer.

2. The payment was made for services to the payer's trade or business (including government agencies and nonprofit organizations).

3. The payment was made to an individual, partnership, estate or (in some cases) a corporation. There are certain Box 1 reportable payments to corporations including (but not limited to) cash payments for fish (or other aquatic life) purchased from anyone engaged in the trade or business of catching fish; attorney fees paid in a payer's trade or business; and payments by a federal executive agency for services (vendors).

4. The payer made payments to the payee of at least $600 during the year.

NOTE: According to CCA 201447025, payments to LLCs are exempt from the IRC Sec. 6041 reporting requirements only if the LLC has elected to be classified for federal tax purposes as a corporation by filing Form 8832, Entity Classification Election. Therefore, payments to LLCs classified as either partnerships or disregarded entities are generally not exempt from information reporting requirements.

Certain trade or business payments may still need to be reported on Form 1099-MISC, Miscellaneous Income (e.g., rents in box 1 or other income payments in box 3). Form 1099-MISC must be filed by March 1, 2021, if filed on paper, or March 31, 2021, if filed electronically.

For small businesses with gross receipts (average annual gross receipts for the most recent three years) of $5 million or less, the penalty for filing 2021 Form(s) 1099 late is $50 per return, with a maximum penalty of $199,500. The penalties increase to $110 per return (maximum of $571,000) if 31 days or more late (up to August 1), $280 per return (maximum of $1.142 million) if filed after August 1, 2022, or not at all. Taxpayers deemed to have intentionally disregarded the filing requirement are subject to a $570 per return (no maximum) penalty.

Income

Gross receipts or sales (line 1) includes all gross receipts from the taxpayer's trade or business, including barter income.

RECENT COURT CASES: In *Frey*, the Tax Court found that income a stockbroker earned from his work as an employee of a business that he controlled could not be assigned to another defunct corporation that he owned. There is longstanding authority for the rule that income is taxable to the person who earns it. This rule has been applied consistently in various contexts in which taxpayers have attempted to shift the incidence of taxation to a person or entity having less or no tax liability. The determination of the proper taxpayer depends upon which person or entity in fact controls earning the income rather than who ultimately receives the income. The Court agreed with the IRS that Mr. Frey (and not the corporation) at all times controlled the earning of the income. (*Frey v. Comm.*, T.C. Memo 2019-62)

In *Fleischer*, the Tax Court concluded that a financial consultant, rather than his S corporation, should have reported the income earned in his individual capacity under a representative agreement and broker contract for the years in issue. While the first principle of income taxation is that income must be taxed to the person who earned it, courts have found that it's impractical to apply a simplistic "who earned the income?" test when the choices are a corporation and its service-provider employee. Instead, the question has evolved to one of "who controls the earning of the income?" For a corporation, not its service-provider employee, to be the controller of the income, two elements must be found:

1. the individual providing the services must be an employee of the corporation whom the corporation can direct and control in a meaningful sense; and
2. there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position [Reg. §31.3121(d)-1(c)(2)]. (*Fleischer v. Comm.*, T.C. Memo 2016-238)

Barter, or the swapping of goods and services, results in gross income to each party to the swap to the extent of the fair market value of the goods or services received, whether in actual goods or the dollar value of barter credits received by members of barter clubs.

If the total amounts that were reported in box 1 of Forms 1099-NEC (2021) are more than the total the taxpayer is reporting on line 1, attach a statement explaining the difference (or if appropriate, request a corrected Form 1099-NEC).

Sole proprietor taxpayers that accept debit, credit or stored-value cards or third-party network payments (e.g., PayPal) may also receive Form 1099-K, Payment Card and Third-Party Network Transactions.

PLANNING TIP: The minimum reporting thresholds of greater than $20,000 and more than 200 transactions apply only to payments settled through a third-party network; there is no threshold for payment card transactions.

A taxpayer cannot exclude a payment received from income simply because the payer did not file an information return (T.C. Memo 2012-317).

State and local sales taxes imposed on the buyer, which the taxpayer is required to collect and pay over to state or local governments, are not income.

"Other income" on Line 6 should include amounts from finance reserve income, scrap sales, bad debts recovered, interest (such as on notes and accounts receivable), state gasoline or fuel tax refunds received in 2021, any amount of credit for biofuel claimed on line 2 of Form 6478, any amount of credit for biodiesel and renewable diesel fuels claimed on line 8 of Form 8864, credit for federal tax paid on fuels claimed on a 2019 Form 1040, prizes and awards related to a trade or business, and other kinds of miscellaneous business income. Include amounts received in the trade or business as shown on Form 1099-PATR, Taxable Distributions Received from Cooperatives.

If the business use percentage of any listed property dropped to 50% or less in the current tax year, report on this line any recapture of excess depreciation, including any IRC Sec. 179 expense deduction. Use Part IV of Form 4797 to figure the recapture. Also, if the business use percentage drops to 50% or less on leased listed property (other than a vehicle), include on this line any inclusion amount.

NEW DEVELOPMENT: The Families First and Coronavirus Relief Act (FFCRA) was extended with the American Rescue Act Plan of 2021. The FFCRA provides businesses with tax credits to cover certain costs of providing employees with required paid sick leave and expanded family and medical leave for reasons related to COVID-19, from April 1, 2020, through September 30, 2021.

An eligible employer must include the full amount of the credits for qualified leave wages (and any allocable qualified health plan expenses and the eligible employer's share of the Medicare tax on the qualified leave wages) in gross income.

EXAMPLE: Treatment of sick leave wages

Josh Goodman (a Schedule C taxpayer) employs three unrelated individuals in 2021, one of whom receives required paid sick leave under the FFCRA and related DOL guidance.

Josh claims a credit of $5,510 for $5,110 of qualified sick leave wages and $400 of health plan expenses paid for the employee during the period of required paid leave. On his 2021 Schedule C, Josh has an offsetting income inclusion amount of $5,510, and he may deduct $5,110 of qualified sick leave wages and $400 of health plan expenses (assuming such costs are not subject to capitalization).

Expenses

Deductible expenses must meet six separate elements:

1. it must be ordinary,
2. it must be necessary,
3. it must be an expense as opposed to a capital expenditure,
4. it must be paid or incurred during the taxable year,
5. the expense has to be in carrying on the activity, and
6. the activity has to be a trade or business [IRC Sec 162(a)].

COURT CASES: In *Berry,* the IRS challenged a $122,000 deduction claimed by the business owners of a construction business for their race car expenses. The father and son business owners purchased a 1968 Chevrolet Camaro in 2013 and restored it. They began racing the car in 2014. The son's racing activities were conducted under the name "Berry Racing." Although the taxpayers testified that the Camaro featured advertising for the construction business, no company logo or wordmark was visible in the only photograph of the car they presented to the Tax Court. In addition, the taxpayers were unable to provide evidence that any of their contacts in racing led to any construction business. The taxpayers could not demonstrate that the expenses were either ordinary or necessary to the business. (*Andrew M. Berry, et ux. v. Comm.,* TC Memo 2021-42)

In *Constello et al*, the taxpayers owned land on which they tried raising chickens, crops, and beef. None of their efforts resulted in a salable product. The Tax Court sided with the IRS these activities did not amount to carrying on a trade or business because nothing was held for sale or sold. (*William Bruce Constello and Martiza Legarcie v. Comm.*, TC Memo 2021-9)

Cost of Goods

Cost of goods sold are deductible if the taxpayer makes or buys goods to sell. As discussed above, taxpayers that meet the $25 million ($26 million in 2020 and 2021) gross receipts test aren't required to account for inventories under IRC Sec. 471, but rather may use a method of accounting for inventories that either—

1. treats inventories as non-incidental materials and supplies, or

2. conforms to the taxpayer's financial accounting treatment of inventories.

A small taxpayer being exempt from keeping inventory under IRC Sec. 471 does not necessarily translate to an immediate tax write-off for all inventoriable costs.

The final Regulations clarify that for small taxpayers who choose the NIMS inventory method, even though these amounts are treated as nonincidental materials and supplies, they still retain their character as inventory. The final Regulations retain the general rule that "used and consumed" threshold for NIMS is met only when the taxpayer sells the inventory. Therefore, manufacturers which convert raw materials into a work in progress or finished goods by year end but have not yet sold the inventory will not be able to deduct the costs under the final Regulation.

While some manufacturers have taken the position that their raw materials are deductible when first used and consumed in the manufacturing process, these taxpayers will likely need to file a method change to comply with the final Regulation.

Donated Inventory

When a taxpayer contributes inventory, the amount claimed as a contribution deduction is the lesser of its fair market value on the day it was contributed or its basis.

NEW DEVELOPMENT: The 2021 Consolidated Appropriations Act extended the increase of the limitation for the deduction for donations of food inventory in a tax year from 15% to 25% through 2021. Under the CARES Act, the increased deduction limitation for food inventory donations is available only to taxpayers other than C corporations.

PLANNING TIP: Reg. §1.170A-1(c)(4) indicates that, if the cost of the contributed inventory was incurred in the year of contribution and those costs would normally be included in cost of goods sold, the deduction for the items will effectively be taken as part of cost of goods sold. If the inventory is contributed in a year subsequent to the year its cost was incurred, and the costs are included in beginning inventory, the contribution is removed from inventory and is not included in cost of goods sold, but rather is deducted under IRC Sec. 170 as a charitable contribution.

In the event the taxpayer withdraws merchandise for personal or family use, he must exclude this cost from the total amount of merchandise he bought for sale. This is done by crediting the purchases or sales account with the cost of merchandise he withdraws for personal use.

PLANNING TIP: Divide gross profit by gross receipts and compare this percentage to a client's markup policy or to prior years. Significant fluctuations in these percentages may indicate a problem. The IRS keeps statistics on tax returns on its website. Information about different industries, including income and deductions that can be used to calculate profit percentages, is available at **www.irs.gov/taxstats** and **www.bizminer.com**.

Car and Truck Expenses

Taxpayers can deduct the actual expenses of operating a car (or truck) or take the standard mileage rate. This is true even if the vehicle is used for hire (such as a taxi cab). A taxpayer must use actual expenses if five or more vehicles are used simultaneously in the business (such as in fleet operations). A taxpayer *cannot* use actual expenses for a leased vehicle if they previously used the standard mileage rate for that vehicle. The standard mileage rate for 2021 of $ .56. See Chapter 30 for more information.

Depreciation

See Chapter 30 for more detailed discussion on depreciation.

Employee Benefit Programs

Taxpayers may deduct contributions to employee benefit programs that are not an incidental part of a pension or profit-sharing plan. Examples include accident and health plans, group-term life insurance, and dependent care assistance programs. (See the discussion regarding qualified small employer health reimbursement arrangements which follows.)

Taxpayers *cannot* deduct contributions made on their own behalf as a self-employed person for group-term life insurance.

Taxpayers *cannot* deduct on Schedule C any contributions made on their own behalf as a self-employed person to an accident and health plan.

Interest

The tax treatment of interest expense differs depending on its type. Interest allocation rules require taxpayers to allocate (classify) interest expense, so it is deducted (or capitalized) on the correct line of the return and receives the right tax treatment. See Chapter 7 for more information on the interest tracing rules.

IRC Sec. 163(j): The TCJA added IRC Sec. 163(j), which limits the business interest expense deduction for certain taxpayers. There are several exceptions to the application of this limit. The most important applies to businesses (other than tax shelters) with average annual gross receipts for the three-tax-year period ending with the prior tax year of $25 million or less ($26 million or less for 2021) [IRC Sec(s). 448(c) and 163(j)(3)]. The IRS issued final Regulations (600 pages of them!) under IRC Sec. 163(j) in July 2020.

Pension and Profit-Sharing Plans

A deduction is available for contributions to a pension, profit-sharing, or annuity plan (including SEP, SIMPLE and SARSEP plans) for the benefit of the taxpayer's employees. If the plan included the taxpayer as a self-employed person, enter the contributions made as an employer on his behalf on Schedule 1, Additional Income and Adjustments to Income, Form 1040, not on Schedule C.

Travel Expenses

Travel expenses are the ordinary and necessary expenses of traveling away from home for business. The taxpayer is traveling away from home if both the following conditions are met:

1. The taxpayer's duties require him to be away from the general area of his tax home substantially longer than an ordinary day's work.

2. Taxpayer needs to get sleep or rest to meet the demands of his work while away from home.

> **PLANNING TIP:** Generally, *tax home* means the taxpayer's regular place of business, regardless of where the taxpayer's family home is. It includes the entire city or general area in which the taxpayer's business is located.

Meals and Entertainment

Under the TCJA, no deduction is allowed for—

1. an activity generally considered to be entertainment, amusement, or recreation,

2. membership dues for any club organized for business, pleasure, recreation, or other social purposes, or

3. a facility used in connection with any of the above items.

Entertainment expenses are now completely nondeductible, regardless of whether they are directly related to or associated with the taxpayer's business, unless one of the exceptions in IRC Sec. 274(e) (e.g., meetings of business leagues) applies. See Chapter 24 for further information.

Other Expenses

Other commonly deducted expenses include advertising, bank fees, donations to business organizations, education expenses, impairment-related expenses, licenses and regulatory fees, outplacement services, penalties and fines paid for late or nonperformance of a contract, repairs that keep property in a normal efficient operating condition, repayments of income, subscriptions to trade or professional publications, supplies and materials and utilities.

Taxpayers generally may not deduct the following expenses on Schedule C:

1. Bribes and kickbacks.

2. Charitable contributions (unless qualify as advertising).

3. Demolition expenses or losses.

4. Dues to business, social, athletic, luncheon, sporting, airline, and hotel clubs.
5. Lobbying expenses (including local lobbying expenditures).
6. Penalties and fines paid to a governmental agency or instrumentality because the business broke the law.
7. Personal, living, and family expenses.
8. Political contributions.
9. Repairs that add to the value of property or significantly increase its life.

NEW DEVELOPMENT: Self-employed individuals are not eligible for the CARES Act's employee retention credit with respect to their own self-employment earnings. However, a self-employed individual who employs individuals in its trade or business and who otherwise meets the requirements to be an eligible employer may be eligible for the employee retention credit with respect to qualified wages paid to the employees. See Chapter 13 for more information.

SHARING ECONOMY CONSIDERATIONS

Taxpayers that use one of the many online platforms available to rent a spare bedroom, provide car rides, or to connect and provide a number of other goods or services are involved in what is sometimes called the *sharing economy* (also known as the *on-demand*, *gig*, or *access* economy).

Although this is a developing area of the economy, there are tax implications for the companies that provide the services and the individuals who perform the services.

PLANNING TIP: The IRS has developed additional resources for these taxpayers, including the Sharing Economy Tax Center available at **www.irs.gov/businesses/small-businesses-self-employed/sharing-economy-tax-center**.

The IRS has identified the key tax issues that apply to those participating in the sharing economy:

1. **Filing requirements.** Sharing economy activity is generally taxable. It does not matter whether it is only part-time or a sideline business, if payments are in cash or if an information return like a Form 1099 or Form W-2 is issued. The activity is generally taxable.
2. **Employee or independent contractor status.** Both Lyft and Uber drivers are classified by the online platforms as independent contractors.
3. **Tax payments** (including estimated tax payments).
4. **Self-employment taxes.**
5. **Depreciation.**

EXAMPLE: Timing of rental property depreciation

On April 6, Jay bought a 2,000 square foot house to use as a rental property. He does not use the property as his personal residence.

Jay planned to use an online app to advertise and to rent the house for short durations on a full-time basis. He made several repairs and had it ready for rent on July 5. At that time, Jay offered the house for rent through the online app. The house is considered placed in service in July when it was ready and available for rent. Jay can begin to depreciate the home's cost in July.

Rules for Home Rentals

Rental income for the use of a house or an apartment, including a vacation home, must be reported in most cases. Certain expenses may be deductible against the rental income, but special rules and limits often apply. (See Chapter 34 for further discussion.)

If the dwelling unit is used for both rental and personal purposes, the taxpayer generally must divide the total expenses between the rental use and the personal use based on the number of days used for each purpose.

EXAMPLE: Calculating certain rental expense deductions when rental is also primary residence

Anna used an online app to rent a room in her house 73 days last year, or 20% of the year. The room is 12 feet × 15 feet, or 180 square feet. Anna's entire house has 1,800 square feet of floor space.

She can deduct as a rental expense 10% of any expense that must be divided between rental use and personal use, divided again by the percentage of the time the room was available for rent during the year.

For example, if Anna's heating bill for the year for the entire house was $600, only $12 ($600 × 0.10 × 0.20) is a rental expense. The balance of $588 is a personal expense that she cannot deduct.

There is a special rule if the taxpayer uses a dwelling unit as a personal residence and rents it for fewer than 15 days. In that case, the taxpayer will not report rental income or deduct any expenses as rental expenses.

Taxpayers that provide substantial services that are primarily for a tenant's convenience, such as regular cleaning, changing linens, or maid service, must instead report rental income and expenses on Schedule C. Substantial services don't include such things as heat and light, cleaning of public areas, or trash collection.

Receiving Form 1099-K, Payment Card and Third-Party Network

<u>Business Expenses.</u>

Rideshare drivers must allocate automobile expenses between personal and business use. The *business stop rule* says that the mileage incurred in driving from the taxpayer's residence to the first passenger pickup, as well as the mileage from the last drop-off point back home are non-deductible personal commuting miles. Either the actual expense method or standard mileage method ($ .56 per mile for 2021) may be used.

Expenses are subject to allocation between business use and personal use, based upon the business miles. These include Uber fuel card fees, vehicle property taxes, vehicle loan interest, lease payments, fuel, oil, tires, repairs, and maintenance (including car washes), insurance, registration, tags, and parking.

Fully deductible expenses may include Uber (or Lyft) fees and subscriptions, tolls, city and airport fees, safe ride fees, Black Car Fund fees, and the cost of refreshments provided solely to riders.

Mobile phone expenses must be allocated between personal and business use. For simplicity's sake, a separate dedicated business phone may be preferable.

MARIJUANA INDUSTRY CONSIDERATIONS

Despite the legalization of marijuana (for medical or recreational use) in a majority of states and the District of Columbia, under federal law marijuana remains classified as a Schedule I controlled substance and its sale remains illegal. Per IRC Sec. 280E—

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

Accordingly, marijuana businesses are not entitled to claim ordinary and necessary business expenses otherwise allowed under IRC Sec. 162.

NEW DEVELOPMENT: In *Richmond Patients Group*, a medical marijuana dispensary business wasn't entitled to deduct rent, officer compensation, tax and license fees, and other business-related expenses. The IRS successfully argued that IRC Sec. 280E's prohibition on deductions for expenses related to business that consisted of trafficking in controlled substances applied and precluded subject deductions. Although the taxpayer's business was legal under California law, it was federal law that triggered IRC Sec. 280E. (*Richmond Patients Group v. Comm.*, TC Memo 2020-52)

NEW DEVELOPMENT: The Treasury Inspector General for Tax Administration (TIGTA) released an audit in April 2020 which concluded that the growth of the marijuana industry warrants expanded tax compliance efforts and additional guidance from the IRS. The audit further stated that the IRS "risks diminished taxpayer compliance when marijuana businesses fail to report all income as required under IRC Sec. 61, regardless of source, and deduct expenses not allowed under IRC Sec. 280E." TIGTA's statistical random sampling of marijuana businesses in three states determined that 59% (140 out of 237) of tax returns for 2016 likely had Section 280E adjustments, which "when projected over the population, totaled $48.5 million in unassessed taxes for 2016 or $242.6 million when the results are forecast over five years." The audit revealed that the IRS lacks guidance for taxpayers and tax professionals in the marijuana industry.

RECENT COURT CASES: In *Loughman*, the Tax Court held that an S corporation that grew and sold medical marijuana couldn't deduct the wages it paid to the company's owners. The central issue for the Tax Court to consider was whether the S corporation could deduct the portion of the wages it paid to the taxpayers. The parties agreed that these disallowed wage deductions couldn't be characterized as COGS, and that in disallowing any of the wage deductions, the taxpayers' flow-through income from the S corporation would increase. (*Loughman v. Comm.*, TC Memo 2018-85)

The taxpayers maintained that the IRS's treatment of their wage income as an expense subject to IRC Sec. 280E caused the same income to be taxed twice, once as wages, and a second time as S corporation income. The taxpayers contended that this treatment was contrary to the purpose and legislative intent of subchapter S. The Tax Court concluded that applying IRC Sec. 280E to deny the S corporation's wage expense deductions wasn't discriminatory; it applied equally, regardless of whether the taxpayers themselves or a third party received the wages.

In *Alterman*, a medical marijuana dispensary LLC's sole owner wasn't entitled under IRC Sec. 280E to deduct expenses relating to dispensary business since it consisted of trafficking in controlled substances. Although the taxpayer argued that because LLC also sold merchandise that was used to consume but didn't contain marijuana, and therefore was a separate business to which IRC Sec. 280E didn't apply, that argument was belied by facts that LLC derived almost all its revenue from marijuana merchandise, showing there was only one unitary business. (*Alterman v. Comm.*, TC Memo 2018-83)

However, in (CHAMP), the Tax Court determined that the taxpayer's provision of caregiving services and its provision of medical marijuana were separate trades or businesses for the purposes of IRC Sec. 280E. The taxpayer was not precluded from deducting Section 162 expenses attributable to the caregiving services. [*Californians Helping to Alleviate Medical Problems (CHAMP), Inc. v. Comm.*, 128 T.C. 173]

In CCA 201504011, the IRS concluded that persons who traffic in Schedule I and Schedule II controlled substances (i.e., marijuana) can currently deduct cost of goods sold (COGS) but must determine COGS by using rules that existed before the enactment of IRC Sec. 263A to determine inventoriable costs.

PLANNING TIP: When IRC Sec. 280E was enacted, taxpayers using an inventory method were subject to the inventory-costing regulations under IRC Sec. 471. Specifically, resellers were subject to Reg. §1.471-3(b), and producers were subject to Reg. §1.471-3(c) and Reg. §1.471-11 "certain indirect and production costs."

Under Reg. §1.471-11(c), indirect production costs which must enter into the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include repair and maintenance expenses, utilities, rent, certain indirect labor and production supervisory wages, indirect materials and supplies, tools and equipment not capitalized, and costs of quality control and inspection. Additionally, if a marijuana business has a GAAP financial statement prepared, inventory can also include certain additional costs to the extent that they are properly allocated to inventory for GAAP purposes such as taxes, depreciation, cost of employee benefits, and certain production expenses (administrative, officers' salaries, insurance).

The marijuana business is largely a cash-basis industry. The law requires that trade and businesses report cash payments of more than $10,000 by filing Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business. *Cash* includes the coins and currency of the U.S. and foreign countries, and may include cashier's checks, bank drafts, traveler's checks, and money orders with a face value of $10,000. Cash *does not* include personal checks drawn on the buyer's account, or a cashier's check, bank draft, traveler's check, or money order with a face value of more than $10,000 (see separate FinCEN Currency Treasury Report filing requirements).

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

1. The amount of cash is more than $10,000.
2. The business receives the cash as:
    a. One lump sum of more than $10,000, or
    b. Installment payments that cause the total cash received within one year of the initial payment to total more than $10,000, or
3. Previously unreported payments that cause the total cash received within a 12-month period to total more than $10,000.
4. The establishment receives the cash in the ordinary course of a trade or business.
5. The same agent or buyer provides the cash.
6. The business receives the cash in a single transaction or in related transactions.

Related transactions are transactions between a payer, or an agent of the payer, and a recipient of cash that occur 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. Transactions are related even if they are more than 24 hours apart when a business knows, or has reason to know, that each is a series of connected transactions.

EXAMPLE: Treatment of two or more related cash transactions totaling $10,000 or more which are more than 24 hours apart

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.

PLANNING TIP: Contractors must file Form 8300 if they receive cash of more than $10,000 for building, renovating, remodeling, landscaping, and painting.

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 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.

Tax practitioners advising clients in the marijuana industry are advised to carefully consider ethical guidance as issued by their state board of accountancy and the AICPA. The AICPA's 2016 An Issue Brief on State Marijuana Laws and the CPA Profession gives an overview of U.S. recreational and medicinal marijuana laws, recent legislative/regulatory environment, and information for CPAs considering providing services to businesses that operate in these industries.

> **NEW DEVELOPMENT:** In FS-2020-11, the IRS issued a Fact Sheet titled Reporting Cash Transaction Helps Government Combat Criminal Activities (available at www.irs.gov/newsroom/reporting-cash-transactions-helps-government-combat-criminal-activities).

SUBSTANTIATION REQUIREMENTS UNDER IRC SEC. 162

Reg. §1.6001-1(a) requires all taxpayers to maintain books and records to establish the amount of income, deductions and credits claimed on a tax return. Taxpayers must have evidence proving the amount of the expense and the character of the expense (e.g., business versus personal).

Proof of payment alone does not establish a deduction. It must also be shown to be an ordinary and necessary expense. Keeping invoices, sales slips, and receipts are necessary to show the nature of the expense and its proper character.

Rev. Proc. 92-71 outlines what is considered proof of payment. Unfortunately, this procedure is out-of-date as few taxpayers receive cancelled checks anymore. The IRS will accept as proof a statement prepared by a financial institution that shows all the following:

1. The check number,
2. The amount of the check,
3. Date the check was posted to the account by the financial institution, and
4. The name of the payee.

Most financial institutions do not list the payee on the statement. Other evidence such as an invoice, a carbon copy of the check or an electronic copy of the check may be required.

For payments made via credit card, the requirements are similar. An account statement prepared by a financial institution showing a credit card charge will be accepted as proof of payment if the statement shows:

1. The amount of the charge,
2. The dated of the charged by the cardholder (transaction date), and
3. The name of the payee.

When taxpayers don't have the required documentation but are credible and possess some evidence to support the existence of the deductions, courts have the discretion to allow partial deductions "bearing heavily against the taxpayer whose inexactitude is of his or her own making" [*Cohan v. Comm.*, 39 F2d 540 (2d Cir. 1930)]. The *Cohan* rule does not apply when stricter substantiation is required under IRC Sec. 274(d).

Both Circular 230 [Section 10.34(d)] and the AICPA Statement on Standards for Tax Services [SSTS #3] impose a duty upon a preparer to make reasonable inquiries, ascertain that the data does not appear to be incorrect, incomplete or inconsistent, and inquire whether the required books and records are maintained and whether substantiating documentation to support the reported deduction or tax treatment is maintained.

AICPA SSTS #4 allows a preparer to appropriately use estimates of expenses where records are missing, or precise information about a transaction is not available. The SSTS cautions that the presentation of the estimates does not imply more accuracy than can be confirmed. Disclosure of estimates is not generally required, except in the unusual circumstances to avoid misleading tax authorities.

SUBSTANTIATION REQUIREMENTS UNDER IRC SEC. 274(d)

IRC Sec. 274(d) provides stricter substantiation requirements for the following expenses:

1. Traveling expenses (including meals and lodging while away from home),
2. Gift expenses, and
3. Accountable plan reimbursement expenses, or expenses related to listed property [IRC Sec. 280F(d)(4)].

If a deduction falls under the stricter substantiation rules, no deduction is allowed without the following additional elements being established via "adequate records or by sufficient evidence corroborating the taxpayer's own statement." The requirements to substantiate the deduction are [IRC Sec. 274(d)]:

1. The amount of the expense or other item,
2. The time and place of the travel or the date and description of the gift,
3. The business purpose of the expense or other item, and
4. The business relationship to the taxpayer of the person receiving the benefit.

The maintenance of an auto log on a weekly basis is considered contemporaneous documentation Reg. §1.274-5T(c)(2)(ii)(A), but the level of detail required for substantiating business use depends upon facts and circumstances [Reg. §1.274-5T(c)(ii)(B)].

Creating records long after the fact doesn't meet the contemporaneous requirement, and if prepared in preparation for audit, may run into violation of Reg. §§1.274-5(c)(2)(iii) and 1.274-5T(c)(2)(ii).

When a taxpayer shows that an inability to produce adequate records is due to circumstances beyond their control, such as a casualty, they are allowed to substantiate deductions through other credible evidence [Reg. §1.274-5T(c)(5)]

RECENT COURT CASES: Taxpayers' inability to substantiate expenses is one of the more common cases to go to tax court. In *Baum,* the husband was self-employed as a consultant and the wife was self-employed as a realtor. The taxpayers filed Schedule C for each of their respective businesses claiming various deductions such as meals and entertainment expenses, office expenses, and car and truck expenses. The IRS disallowed many of these deductions because the taxpayers provided no evidence to support the deductions claimed on their respective Schedules C. (*Ronnie S. Baum v. Comm,* TC Memo 2021-46).

In *Ward*, the taxpayer (an S corporation) claimed officer compensation of $62,388 and wages of $33,925 but only reported compensation totaling $41,483.78 on its Forms 941. The shareholder properly reported the S corporation's loss on Schedule E but failed to report the wages or salaries received. She also reported the company's income and expenses on her Schedule C. The IRS challenged a large number of the company's expenses, including failure to pay tax on the compensation to the sole shareholder and travel expenses to "schmooze" a client. The Court sided with the IRS. (*Lateesa Ward v. Comm.* and *Ward & Ward Company v. Comm.*, TC Memo 2021-32.

In *Adler*, the taxpayer owned a sales and consulting business for the entertainment industry. The taxpayer claimed travel expenses and contract labor expenses which he could not substantiate, and therefore again the Court ruled in favor of the IRS. (*Peter M. Adler v. Comm.,* TC Memo 2021-56.

RELATED PARTY PLANNING OPPORTUNITIES

It is common for parents, sons, daughters, or even grandchildren to work in a family-owned business. Generally, family employment is treated like any other employment, and the employee service performed for the business by family members is covered employment subject to federal income tax withholding (FITW), social security and Medicare (FICA) taxes (including the additional 0.9% Medicare tax), and federal unemployment (FUTA) tax.

A legitimate and bona fide employer and employee relationship must exist.

EXAMPLE: 10-Point Checklist for Family Employees ("No" answers are unfavorable)

	Yes	No
1. Is there a written employment contract between the parties?	____	____
2. Are time records kept at the time of work performance?	____	____
3. Is there a written job description?	____	____
4. Is the employee paid periodically?	____	____
5. Is there a Form I-9 on file for the employee?	____	____
6. Is there a Form W-4 on file for the employee?	____	____
7. Are payroll tax returns filed regularly? (Quarterly Forms 941 and/or annual Form(s) 944 and 940)	____	____
8. Are Forms W-2(s) issued?	____	____
9. Does the employee deposit the check in his own bank account?	____	____
10. Are wages comparable to fair market wages for equivalent work?	____	____

A sole proprietor parent can deduct reasonable wages paid to his unemancipated minor child for personal services actually rendered as a bona fide employee [*Eller v. Comm.*, 77 T.C. 934; TC Memo 2016-136 (*Embroidery Express, LLC*)].

PLANNING TIP: Payments for the services of a child under age 18 who works for his parent in a trade or business aren't subject to social security and Medicare taxes if the trade or business is a sole proprietorship or a partnership in which each partner is a parent of the child. Payments for the services of a child under age 21 who works for his parent, regardless of whether in a trade or business, aren't subject to FUTA tax.

When the employer is a child employing a parent, payments for the services of the parent in the employer's trade or business are subject to income tax withholding and social security and Medicare taxes. Payments made to a parent employed by their child aren't subject to FUTA tax, regardless of the type of services provided.

The wages for the services of an individual who works for his spouse in a trade or business are subject to income tax withholding and social security and Medicare taxes, but not to FUTA tax.

Payments under sickness, accident, medical, and similar plans by an employer for the benefit of a bona fide spousal employee are deductible by the employer as ordinary and necessary business expenses [Rev. Rul. 71-588]. Further, the bona fide spouse employee may exclude these amounts from income under IRC Sec. 105(b).

Similarly, a sole proprietor can deduct, as ordinary and necessary business expenses, reimbursements made to his employee-spouse under an accident and health care plan, where the reimbursements were for medical costs incurred by the employee-spouse on behalf of the employee-spouse, the sole proprietor, and their dependents [PLR 9409006].

The 2016 21st Century Cures Act (the Act) allows small employers to provide health reimbursement arrangements (HRAs) to their employees without facing penalties for failing to satisfy certain Affordable Care Act (ACA) requirements.

HRAs typically consist of a promise by an employer to reimburse medical expenses [as defined in IRC Sec. 213(d)] for a year up to a certain amount, with unused amounts available to reimburse medical expenses in future years. The reimbursement is excludable from the employee's income.

HRAs generally are considered to be group health plans for purposes of the IRC, Employee Retirement Income Security Act of 1974 (ERISA), and the Public Health Service Act (PHS Act), provisions of which were incorporated into the IRC by the ACA.

IRC Sec. 4980D imposes an excise tax on any failure of a group health plan to meet the requirements of Chapter 100 ("Group Health Plan Requirements") of the IRC. Employers, whether or not they are applicable large employers (ALEs), are subject to the IRC Sec. 4980D excise tax if they maintain group health plans that don't meet the ACA market reform requirements.

PLANNING TIP: The IRC Sec. 4980D excise tax ($100 per day per affected individual) does not apply to any group health plan that, on the first day of the plan year, has less than two participants that are current employees [IRC Sec. 9831(a)(2)].

Under the Act, a qualified small employer HRA is not treated as a group health plan for (most) income tax purposes. There are similar exceptions for ERISA and PHS Act purposes. Accordingly, a qualified small employer HRA will not face the IRC Sec. 4980D excise tax levied on group health plans that don't meet the ACA market reform requirements.

A *qualified small employer HRA* is one that meets all the following requirements:

1. It is maintained by an eligible employer. An eligible employer is an employer that is not an applicable large employer (i.e., it employs fewer than 50 employees) and does not offer a group health plan to any of its employees;

2. It is provided on the same terms to all eligible employees. Certain exceptions apply. Generally, employers can exclude from participation employees who haven't completed 90 days of service, employees who haven't attained age 25, part-time or seasonal workers, employees covered in a collective bargaining unit, and certain nonresident aliens;

3. It is funded solely by an eligible employer, and no salary reduction contributions may be made under the HRA;

4. It provides, after the employee provides proof of coverage, for the payment (reimbursement) of an eligible employee for expenses for medical care [as defined in IRC Sec. 213(d)] incurred by the eligible employee or the eligible employee's family members (as determined under the HRA's terms); and

5. The 2021/ 2020 amount of payments and reimbursements does not exceed $5,300 ($10,700 in the case of an arrangement that also provides for payments or reimbursements for family members of the employee). Amounts reimbursed may include the cost of individual insurance and Medicare premiums.

An employer funding a qualified arrangement for any year must (generally not later than 90 days before the beginning of such year) provide a written notice to each eligible employee. See Notice 2017-67 for more information.

Certain rent paid between spouses is deductible as a Schedule C trade or business expense. IRC Sec. 162(a)(3) states that a taxpayer can only deduct rent for property "in which he has no equity." No deduction is allowed where the proprietor solely owns the property, or where the property is titled jointly, with rights of survivorship. Rent paid for the use of property owned outright by a spouse is deductible.

COURT CASE: in *Cox*, the 8th Circuit Court of Appeals held that the Tax Court properly limited a taxpayer's deduction to half on rent that the husband paid for his law office on property they owned as tenants by entirety. Under state law, the ownership interest was in spouses, and the husband could not deduct rent paid for his half of equity interest. Also, the fact that the law practice lacked an ownership interest in the building was irrelevant because as a sole practitioner, the husband was not a separate entity from his law practice. [*Cox v. Comm.*, 80 AFTR 2d 97-5718 (121 F.3d 390), (CA8), 8/05/1997]

The taxpayer will claim a Schedule C deduction, and report Schedule E rental income. The rent must be reasonable and Form 1099-MISC should be issued to the lessor.

Note that the self-rental recharacterization rule applies even when one spouse owns the property and the other spouse pays the rent [*Connor v. Comm.*, 86 AFTR 2d 2000-5201 (218 F.3d 733)]

WHERE TO GO FOR MORE INFORMATION

- IRS Audit Technique Guide, *IRC Sec. 183: Activities Not Engaged in For Profit (ATG)*
- IRS Pub. 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C)*
- IRS Pub. 463, *Travel, Gift and Car Expenses*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 583, *Starting a Business and Keeping Records*
- IRS Small Business and Self-Employed Tax Center at **www.irs.gov/businesses/small-businesses-self-employed**
- IRS Form 8300 Reference Guide at **www.irs.gov/businesses/small-businesses-self-employed/irs-form-8300-reference-guide**

CHAPTER 24: TRAVEL, MEALS, AND ENTERTAINMENT

Learning Objectives

Completion of this chapter will enable participants to—

- Inform Clients about the new 100% meal deduction concerning meals from restaurants.
- Correctly report the income and benefit aspects associated with travel, meals, and entertainment.

NEW LAW AND NOTICES

NEW LAW: Amounts paid for food or beverages provided by a restaurant during calendar years 2021 and 2022 are 100% deductible as a business expense [IRC Sec. 274(n)(2)(D)]. Meals delivered by a restaurant will also be 100% deductible. However, an employer who prepares meals in an employer-operated eating facility is not considered to be operating a restaurant and, therefore, remains subject to the 50% deduction limitation (IRS Notice 2021-25).

This law change is not reflected in final Regulations published in October 2020 which address the effects of the Tax Cuts and Jobs Act (TCJA) on business deductions for food or beverage expenses (see Reg. §1.274-12**).**

Restaurant Defined

The IRS has clarified that, for purposes of the 100% deduction, the term *restaurant* means a business which prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises (IRS Notice 2021-25).

A business that primarily sells pre-packaged food or beverages not for immediate consumption is not considered a restaurant. Therefore, food or beverages purchased at a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk are not treated as food purchased from a restaurant and continue to be subject to the 50% deduction limitation.

Additionally, for Section 274(n)(2)(D) purposes, the following facilities *are not* considered a restaurant (IRS Notice 2021-25):

- Any eating facility located on the employer's business premises that furnishes meals to employees that are excluded from the employee's income under IRC Sec. 119.
- Any employer-operated eating facility treated as a *de minimis* fringe benefit under IRC Sec. 132(e)(2) even if operated by a third party.

ENTERTAINMENT EXPENSES

No deduction is allowed for any activity that is generally considered to be entertainment, amusement or recreation paid or incurred after December 31, 2017. [IRC Sec. 274(a)(1)(A)**;** Reg. §1.274-11(a)]**.**

LAW CHANGE ALERT: New Regulations concerning the disallowance of deductions for entertainment are effective October 9, 2020. These Regulations apply to taxable years which begin on or after October 9, 2020.

Entertainment Defined

Entertainment is generally considered to include entertainment, amusement, or recreation [IRC Sec. 274(a)(1)(A); Reg. §1.274-11(b)(1)(i)]. Under the definition the following would generally be fall under the definition: 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 the taxpayer's family. These activities are treated as entertainment, subject to the objective test described below, regardless of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business. The term *entertainment* includes entertaining on yachts and at social gatherings at home.

Entertainment does not include activities that, although satisfying personal, living, or family needs of an individual, are clearly not regarded as entertainment, such as the providing of a hotel room maintained by an employer for lodging of employees while in business travel status or an automobile used in the active conduct of trade or business, even though used for routine personal purposes such as commuting to and from work.

On the other hand, providing a hotel room or an automobile by an employer to an employee who is on vacation or an airplane to transport an employee and the employee's spouse to and from vacation sites, is entertainment. So is furnishing an apartment at a beach resort to a customer to get the customer's goodwill. Potentially, they would be deductible if added to the employee’s W-2 income.

An “objective test” is used to determine if an expenditure is entertainment. In applying the test, the taxpayer’s trade or business is considered. The test precludes arguments that “entertainment” means only entertainment for others or that the expenditure should be characterized as advertising or public relations:

- Amounts paid by a racetrack to stage invitation-only galas, dinners, and similar events before high-profile horse races were *entertainment* even though the purpose of the expenditures was to promote the races. Notably, no horseracing business was conducted at events, which were simply social occasions held at venues other than the track and were not open to the general gaming/wagering public which composed the bulk of the taxpayers’ usual customers. [*Churchill Downs Inc & Subsidiaries v. Comm.*, (2002, CA6) 90 AFTR 2d 2002-6615].

- A law firm whose clients included members of large labor organizations with workers' compensation cases, personal injury cases, and other legal claims spent over $150,000 a year on daily dinner and luncheon meetings for 1–15 people at which the firm's services were explained. Banquets were also held for this purpose, and key people were taken to sporting events. These expenditures were entertainment expenses. [*Silverton, Ronald R. v. Comm.*, (1977) TC Memo 1977-198, PH TCM].

- A property developer who used his fishing yacht to market his properties to wealthy anglers at fishing tournaments couldn't deduct the yacht expenses. Fishing trips were entertainment under the Regulations’ objective test (above). Although taxpayer did sell units to customers he met at the tournaments, that did not turn the entertainment expenses into deductible marketing expenses. [*Becnel, Damon R. v. Comm.*, (2018) TC Memo 2018-120].

- A dress manufacturer conducted a fashion show to introduce its products to a group of store buyers, the show generally would not be considered entertainment, because the fashion show was attended by the taxpayer's primary customers and the taxpayer's product was present at the event and was the focus of it [Reg. §1.274-11(b)(1)(iii)].

- The expenses of a solar heater salesman, who held sales seminars in his home at which refreshments were served, were not considered entertainment expenses. Displaying one's wares to customers, even in an entertaining way, isn't *entertainment*. Food was an incidental part of the seminars and didn't convert taxpayer's sales talks into entertainment. [*Matlock, Robert (a.k.a. R. D. Matlock) v. Comm.*, (1992) TC Memo 1992-324]

Food or Beverages

Under Reg. §1.274-11(b(1)(ii) [definitions], the term *entertainment* does not include food or beverages unless the food or beverages are provided at or during an entertainment activity. Food or beverages provided at or during an entertainment activity generally are treated as part of the entertainment activity.

Separate Purchase Exception

In the case of food or beverages provided at or during an entertainment activity, the food or beverages are not considered entertainment if the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue's usual selling cost for those items if they were to be purchased separately from the entertainment or must approximate the reasonable value of those items.

If the food or beverages are not purchased separately from the entertainment, or the cost of the food or beverages is not stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation between entertainment and food or beverage expenses may be made and, except as further provided in IRC Sec. 274(e), the entire amount is a nondeductible entertainment expenditure under IRC Sec(s). 274(e) and 274(a).

Section 274(e) Exceptions to the Disallowance

IRC Sec. 274(e) was not changed by the TCJA. The following continue to be deductible as exceptions [IRC Sec. 274(e)]:

1. Food and beverages furnished on the business premises primarily for employees. The TCJA limits the deductibility of these expenses to 50% after December 31, 2017 and makes them nondeductible after December 31, 2025.

2. Expenses treated as compensation. The entertainment or recreation is treated as compensation to an employee [IRC Sec. 274(e)(2)]. These are 100% deductible as an exception under IRC Sec. 274(n)(2)(A).

3. Reimbursed expenses incurred on behalf of another person (does not have to be an employer) under a reimbursement or other expense allowance arrangement [IRC Sec. 274(e)(3)]. These are 100% deductible as an exception under IRC Sec. 274(n)(2)(A) only for 2021 and 2022.

4. Recreational, social, or similar activities primarily for the benefit of employees other than highly compensated employees [IRC Sec. 274(e)(4)]. These are 100% deductible as an exception under IRC Sec. 274(n)(2)(A).

5. Employee, stockholder, business meetings. Expenses incurred which are directly related to business meetings of his employees, stockholders, agents, or directors [IRC Sec. 274(e)(5)].

6. Meeting of business leagues etc. Expenses related and necessary to attend a business meeting or convention of any organization described in IRC Sec. 501(c)(6), related to business leagues, chambers of commerce, real estate boards, and boards of trade [IRC Sec. 274(e)(6)].

7. Items made available to the public (e.g., promotional popcorn, snacks at a car dealership, or in-house "comps" provided by a casino) [IRC Sec. 274(e)(7)]. This exception also applies to meals provided to potential customers as part of a sales presentation (PLR 9414040). It *does not*, however, apply when meals and entertainment are provided on an invitation-only basis and not otherwise available to the public. These are 100% deductible as an exception under IRC Sec. 274(n)(2)(A).

8. Entertainment sold to customers [IRC Sec. 274(e)(8)]. These are 100% deductible as an exception under IRC Sec. 274(n)(2)(A).

9. Expenses includable in income of persons who are not employees includes such items as compensation for services rendered or as a prize or award under IRC Sec. 74 [IRC Sec. 274(e)(9)]. These are 100% deductible as an exception under IRC 274(n)(2)(A).

BUSINESS MEALS

The TCJA generally maintains a meal deduction with some modifications. The Code contains numerous provisions in which a meal can be deducted or excluded from income:

1. IRC Sec. 274(k) deals with business meals.

2. IRC Sec. 132 deals with "fringe benefits excludable from an employee's income.

3. IRC Sec. 119 deals with meals and lodging furnished for the convenience of the employer.

The TCJA keeps the Section 274(k) business meal deduction provided the expense is not lavish and the taxpayer or an employee of the taxpayer is present at the furnishing of such food or beverage.

In general, taxpayers can still deduct 50% of business-related meal expenses, unless an exception applies (see New Law and Notices, earlier in this chapter). The 50% limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed. Examples of meals might include:

- Meals while traveling away from home (whether eating alone or with others) on business, or

- Meal at a business convention or business league meeting.

- Taxes and tips relating to a business meal are included as a cost of the meal and are subject to the 50% limit. However, the cost of transportation to and from the meal is not treated as part of the cost and would not be subject to the limit.

Application of 50% limit

The 50% limit on meal expenses applies if the expense is otherwise deductible and isn't covered by one of the exceptions discussed later. 50% limit also applies to certain meal expenses related to the production of income, including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses. The 50% limit will apply after determining the amount that would otherwise qualify for a deduction.

> **OBSERVATION—Taking Turns Paying for Meals:** If business acquaintances take turns picking up the meal checks primarily for personal reasons, without regard to whether any business purposes are served, no member of the group can deduct any part of the expense.

Exception to the 50% Limit for Meals

The meal expense is not subject to the 50% limit if the expense meets one of the following exceptions:

- Expenses treated as compensation. In general, expenses for goods, services, and facilities, to the extent the expenses are treated by the taxpayer, with respect to entertainment, amusement, or recreation, as compensation to an employee and as wages to the employee for tax purposes.

- Employee's reimbursed expenses. Employees aren't subject to the 50% limit on expenses for which are reimbursed by the employer under an accountable plan.

- Recreational expenses for employees. Recreational expenses for employees are not subject to the 50% limit for expenses for recreational, social, or similar activities (including facilities) such as a holiday party or a summer picnic.

- Advertising expenses. Meals provided to the general public as a means of advertising or promoting goodwill in the community. For example, neither the expense of sponsoring a television or radio show nor the expense of distributing free food and beverages to the general public is subject to the 50% limit.

- Sale of meals. Meals sold to the general public are not subject to the 50% limit if the meals are actually sold to the public. For example, a restaurant's expense for the food furnished to customers isn't subject to the 50% limit.

- Meals provided by Restaurants in 2021 and 2022. See New Law and Notices at the beginning of this chapter.

Exception for Individuals Subject to "Hours of Service" Limits

The taxpayer can deduct a higher percentage of meal expenses while traveling away from home if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. The percentage is 80%. Individuals subject to the Department of Transportation's "hours of service" limits include the following persons:

- Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.

- Interstate truck operators and bus drivers who are under Department of Transportation regulations.
- Certain railroad employees (such as engineers, conductors, train crews, dispatchers, and control operations personnel) who are under Federal Railroad Administration regulations.
- Certain merchant mariners who are under Coast Guard regulations.

TRAVEL

IRC Sec. 162(a)(2) allows for the away-from home travel costs of as deductible business or investment related expenses. However, the TCJA suspended the miscellaneous itemized deduction, so these amounts are no longer deductible as employee business expenses or for investors traveling away from home. This suspension applies from tax years 2018–2025.

Traveling expenses (including amounts paid for meals and lodging that aren't lavish) incurred while away from home in the pursuit of a trade or business are deductible to the extent they're reasonable and necessary to the conduct of the taxpayer's business and are directly attributable to it.

Employee travel expenses paid or incurred in connection with temporary work assignments away from home are deductible business expenses because the employee is in travel status away from his or her current tax home [IRC Sec. 162(a)]. Employer reimbursements of such expenses that are paid under an accountable plan are excluded from the employee's income.

NOTE: An employee's tax home is normally his or her regular or principal (if more than one regular) place of business or post of duty, regardless of where the employee's family home is maintained [*Flowers v. Comm.*, Cite as 34 AFTR 301 (66 S.Ct. 250), Code Sec(s), (S Ct), 01/02/1946)]. The tax home of an employee who has no regular or principal place of business because of the nature of his or her trade or business is their regular place of abode in the real and substantial sense. An employee who does not come within either of these categories is considered an itinerant (i.e., a person who travels from place to place) with no tax home (Rev. Rul. 73-529).

Traveling Away from Home

A taxpayer is traveling away from home if—

- Their duties require them to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work, and
- There is a need to sleep or rest to meet the demands of the work while away from home.

This rest requirement isn’t satisfied by merely napping in the car. The taxpayer doesn’t have to be away from their tax home for a whole day or from dusk to dawn as long as the relief from duty is long enough to get necessary sleep or rest.

EXAMPLES: Determining when an employee is traveling away from home

Scenario 1: A trucker leaves his home terminal on a regularly scheduled round-trip run between two cities and returns home 16 hours later. During the run, the worker has 6 hours off at the turnaround point where he eats two meals and rents a hotel room to get necessary sleep before starting the return trip. The worker is considered to be away from home.

Scenario 2: A truck driver leaves their terminal and returns to it later the same day. They get an hour off at the turnaround point to eat. Because the driver isn't off to get necessary sleep and the brief time off isn't an adequate rest period, they are not considered as traveling away from home.

Members of the Armed Forces

Members of the U.S. Armed Forces on a permanent duty assignment overseas aren't traveling away from home. They cannot deduct expenses for meals and lodging. They can't deduct these expenses even if they maintain a home in the United States for their family members who aren't allowed to accompany them overseas. A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard the ship for travel expense purposes.

Accompanied Travel

IRC Sec. 274(m)(3) and Reg. §1.274-12(a)(4)(iii) disallow a deduction for amounts paid or incurred with respect to a spouse, dependent, or other individual accompanying a taxpayer on business travel unless—

1. the accompanying individual is an employee of the taxpayer,
2. the travel of the accompanying individual is for a bona fide business purpose, and
3. the travel expenses would otherwise be deductible by the accompanying individual.

It may be difficult to convince the IRS that a bona fide business purpose exists when a spouse accompanies a taxpayer on a business trip. Based on a long line of court cases, the presence of the spouse (or other traveling companion) on a trip must be necessary, not merely helpful, to establish the requisite business purpose. Thus, staffing a convention hospitality, hosting a reception, socializing with business associates, or performing light clerical duties (Rev. Rul. 56-168) while on a business trip have all been found insufficient, by themselves, for establishing a bona fide business reason for the spouse's presence.

Other individuals do not include bona fide business associates, such as customers, clients, or professional advisers; expenses incurred for these individuals are not subject to the these rules but are subject to the deductibility requirements that apply to self-employed individuals or employees [Reg. §1.274-2(g)].

EXAMPLE: Spouse as social hostess is not a business purpose

Teddy and his spouse, Lisa, travel to Miami for a two-day business meeting. Lisa works as an employee in Teddy's business. In Miami, Lisa serves as a social hostess for the spouses of the business associates and also attends dinner functions during the two-day period. The IRS may contend that Lisa is performing only incidental services which do not establish a bona fide reason for her presence. Teddy will likely be unable to deduct Lisa's share of the travel costs.

NOTE: Even though a spouse's travel expenses are not deductible, the taxpayer is entitled to deduct the travel expenses they would have incurred to travel alone. For example, if the spouse accompanies the taxpayer on a business trip, only the excess over a single person's travel costs is not deductible. Thus, a taxpayer can claim a deduction for lodging based on single-rate cost of similar accommodations, not half of the double rate actually paid. The deductible amount is generally much more than simply "half" the total costs.

Example: Deducting the appropriate portion of travel costs

Teddy and his wife, Lisa, travel by car from Dallas to Denver on business. They leave on Monday and return on Friday of the same week. Assume that Lisa performs only incidental services and thus cannot establish a bona fide business reason for her presence. Lodging is $150 per night for a double room (assume the single-rate cost is $100 per night). Transportation expense for the 2,000-mile roundtrip at $ .56 per mile (for 2021) is $1,120 (2,000 miles × $ .56 per mile). Meal costs total $800; if Teddy had traveled alone, his meal costs would have been $600.

Teddy is entitled to deduct those costs he would have otherwise incurred to travel alone. Here, he is entitled to deduct $100 per night lodging expense, plus all the transportation costs, and the applicable percentage (100% if provided by a restaurant; 50% otherwise) of the meal costs of $600. The deductible amount is more than simply "half" the total costs.

In a few cases, the courts have found a legitimate business reason for the spouse's presence. Thus, a spouse's travel expenses were deductible where their presence was required by the business, and it helped promote the company's public image, enhance the morale of company representatives, and improved business relationships [*United States v. Disney*, 24 AFTR 2d 69-5123 (413 F.2d 783), (CA9), 06/19/1969; see also *Bank of Stockton v. Comm.*, TC Memo 1977-24].

Example: Deducting the appropriate portion of travel costs—Variation

Assume the same facts as the previous Example, except the meetings are with Spanish-speaking participants. Teddy does not speak Spanish, but Lisa does fluently. Lisa acts as Teddy's translator during the two-day period. There appears to be a bona fide purpose for Lisa's presence on the trip. Thus, Teddy arguably may also deduct Lisa's share of the business travel expenses.

CAUTION: Remember that the spouse's bona fide business purpose alone is not enough. He or she must also be an employee of the taxpayer.

Preserving Deductions for Combined Business/Pleasure Travel

If a taxpayer's trip is undertaken solely for business reasons, all reasonable and necessary travel expenses, including travel fares, lodging, meals, and incidental expenses in getting to and from the destination are deductible (subject to the applicable limitation for meals). So are transportation, lodging, meals, and incidentals incurred while at the destination. This rule applies for both domestic and foreign travel.

However, if the taxpayer's trip involves both business and personal activities, a portion of the travel expenses may be nondeductible personal expenses rather than deductible business expenses. One set of rules applies for domestic travel (i.e., travel within the United States) and a separate set of rules applies to foreign travel (i.e., travel outside the United States). For this purpose, the term *United States* means only the 50 states and the District of Columbia [Reg. §1.274-4(a)].

Domestic Travel

If the taxpayer travels on business in the United States and while at the business destination extends his stay for a vacation, makes a nonbusiness side trip, or has other nonbusiness activities, the proper treatment of the taxpayer's travel expenses depends on how much of the trip was business related. The following guidelines apply [Reg. §1.162-2(b)(1)]:

1. <u>Primarily Business.</u> If the trip was primarily for business, the deductible travel expenses include the costs of getting to and from the business destination and any business-related expenses while at the business destination. Personal (vacation) costs incurred while at the destination are not deductible.

2. <u>Primarily Personal.</u> If the trip was primarily for personal reasons, such as a vacation, the costs of getting to and from the destination are personal (nondeductible) travel costs. Personal costs incurred while at the destination are also nondeductible. However, any business costs incurred while at the destination are deductible expenses.

Whether a trip is primarily business or primarily personal depends on the facts and circumstances in each case. The amount of time spent on business activities compared to the amount spent on personal activities is an important factor. While this is often regarded as a more-than-50% test, no direct IRS authority supports this approach. For example, the IRS states that a trip involving one week of business activities and five weeks of personal activities are considered primarily personal in the absence of a clear showing to the contrary [Reg. §1.162-2(b)(2)].

> **NOTE:** Time spent is only one factor to consider and may not be the dominant factor given the facts-and-circumstances. If the taxpayer would not have taken the trip except to achieve the business purpose, we believe a strong argument can be made that the trip is primarily business. Here, the taxpayer should have a reasonable basis for arguing a “clear showing to the contrary” irrespective of disproportionate amounts of personal time.

Example: Determining whether a trip is primarily business or primarily personal

Teddy Spil has an accounting business located in Philadelphia area. He travels to San Diego on business. On the way, he stops in Santa Fe, NM for four days of rest and relaxation where he spends $950 for personal activities. He spends $830 for roundtrip air travel tickets from Philadelphia to San Diego—with a stopover in Santa Fe. The cost of a direct roundtrip flight from Philadelphia to San Diego is $720. He wraps up his San Diego business after 10 days of meetings and returns home after incurring $920 of lodging, meal, and incidental costs while in San Diego.

It is necessary to determine whether the trip was primarily business or primarily personal. Based strictly on the ratio of time spent on business activities (10 days) to time spent on personal activities (4 days), it is assumed his trip is primarily business. The deductible travel expenses include the $720 airfare cost for a direct roundtrip between Philadelphia and San Diego and the $920 of lodging, meals, and related costs incurred while in San Diego (limited to 50% for meals unless provided by restaurants). The $110 ($830 − $720) of additional airfare costs of getting to Santa Fe, and the $950 of personal costs incurred while at Santa Fe *are not* deductible travel expenses.

Had the trip been primarily personal, the entire $830 of airfare costs and the $950 of personal costs would not be deductible. However, the $920 of business expenses while in San Diego would be deductible as business expenses.

Deducting a Saturday Night Stay

If a taxpayer wraps up a business trip on a Friday and decides to remain at the travel location until the weekend to take advantage of lower return airfare rates, the additional lodging and meal costs incurred are deductible travel expenses if, using a common sense test, a “hardheaded” business person would have incurred the additional expenses under like circumstances (Ltr. Rul. 9237014).

Example: Determining deductibility of a Saturday night stay

Teddy frequently travels for business on Friday and customarily returns home on Saturday. To take advantage of lower “excursion” airfare rates that are available for airline travel on Sundays, Teddy has decided that, when traveling on a Friday, he will stay through Saturday night and return home on Sunday. However, he will do this only if the airfare rate savings realized by utilizing the excursion rates exceeds the one day of additional lodging and meals costs incurred for the Saturday night stay. Teddy will measure the cost savings realized from airfare rates using the lowest available airfare for a direct flight when the trip is originally booked. The Saturday night stays will be undertaken only if they result in an overall cost savings for Teddy. A “hardheaded” business person would do the same. Thus, Teddy should be allowed to deduct the additional lodging and meal costs for the Saturday stay as ordinary business expenses. Meal expenses would be subject to the 50% disallowance rule.

Foreign Travel Deemed Entirely for Business

Generally, a self-employed taxpayer can deduct 100% of foreign travel expenses only if the entire time was spent on business activities. If the majority of time was spent on business activities, the travel expenses are allocated between deductible business expenses and nondeductible personal expenses. If the travel was primarily personal, but there was some business activity, the travel expenses are nondeductible. However, other expenses incurred during the trip that are directly related to business are deductible [Reg. §§1.162-2(b)(1) and 1.274-4(f)(5)(ii)]. Out-of-pocket costs incurred on personal days are never deductible.

Although the foreign travel rules require an allocation of expenses if business travel is combined with personal travel, a safe harbor is provided by IRC Sec. 274(c)(2). If any of the following exceptions is met, allocation of the transportation expenses (getting to and from the destination) on a day-to-day basis is not required. Instead, the taxpayer may deduct those expenses as though the trip was 100% business.

1. No More Than Seven Consecutive Days Are Spent outside the United States. Accordingly, by keeping a foreign business trip to a week or less, 100% of transportation costs and 100% of other out-of-pocket costs for business days (subject to the 50% limit on meals) are deductible. Out-of-pocket costs incurred on personal days are not deductible. For meeting the seven-day test, the day of departure is ignored, but the day of return is included [Reg. §1.274-4(c)].

2. Less Than 25% of the Total Time on the Trip Is Devoted to Nonbusiness Activities. For meeting the 25% test, both the day of departure and the day of return are considered [Reg. §1.274-4(d)]. The same rules for out-of-pocket costs apply as in exception 1.

3. The Taxpayer Has No Substantial Control over Arranging the Trip. A taxpayer who travels for an employer is not considered to have substantial control unless he is a managing executive or related to the employer [Reg. §1.274-4(f)(5)(i)]. (A self-employed individual generally is regarded as having substantial control.)

4. The Taxpayer Establishes That Personal Vacation Was Not a Major Consideration. This test applies even if the taxpayer is self-employed, related to the employer, a managing executive, or has substantial control in planning the trip [Reg. §1.274-4(f)(5)(ii)].

CAUTION: The previous safe harbor tests apply only if the primary purpose of the trip is business; that is, the travel to and from the destination was for a business reason and not for pleasure. "Wrapping" a personal pleasure trip around inconsequential business activities will not allow the taxpayer to use the safe harbors.

EXAMPLE: Combining minimal personal travel with a business trip

Teddy flew to Paris on Sunday to attend several business meetings. He spent Monday through Thursday meeting with various business clients. Instead of returning home immediately after the meetings, he stayed in Paris to do some sightseeing and returned home Sunday.

Teddy's trip meets the seven-day safe harbor exception (Monday-Sunday). The purpose of the trip was primarily business related because four out of seven days were business days. Thus, all of his airfare is deductible, and all of his out-of-pocket expenses incurred on the business days are deductible (subject to the 50% rule for meals not provided by restaurants).

Travel Primarily for Business

If the travel is primarily for business and the taxpayer cannot meet one of the safe harbor exceptions, the travel expenses should be allocated to deductible and nondeductible categories using a day-to-day allocation method (or other method that the taxpayer establishes clearly reflects the allocation) [Reg. §1.274-4(f)(1)]. The following equation is used to calculate deductible travel expenses using the day-by-day method:

$$\text{Total travel expenses} \times \frac{\text{Number of business days}}{\text{Total days outside U.S.}}$$

Both departure and return days are included in the denominator [Reg. §1.274-4(c)]. Transportation days are considered business days if traveling to or from a business destination. The taxpayer must still establish that the primary reason for the trip was for business to allocate any travel expenses to the business activities. Only expenses incurred in connection with the business destination are allocable. For example, if a taxpayer travels from New York to London on business, and then takes a vacation in Paris before returning to New York, the amount of the travel expense subject to allocation is the expense which would have been incurred in traveling from New York to London and returning [Reg. §1.274-4(f)(2)].

If the taxpayer's presence is required at a particular place for a specific and bona fide business purpose, it is considered a business day. If the principal activity is a business pursuit, the day is considered a business day. Weekends and holidays are also business days if they fall between business days [Reg. §1.274-4(d)(2)].

Example: Wrapping business around a weekend

Assume the same facts as the previous example, except Teddy flew to Paris, France on Tuesday, spent Wednesday–Friday in business meetings, did his sightseeing on Saturday and Sunday, and had a five-hour business meeting on Monday. He meets the seven-day safe harbor exception (Wednesday–Monday). Thus, all his travel expenses [including food (50%, but 100% if provided by restaurants) and lodging on the weekend] would be considered business expenses.

Example: Allocating travel expenses of a combined business and pleasure trip

Teddy flew from his hometown in Philadelphia, PA to Munich, Germany on a buying trip involving distressed real estate property. He spent two days meeting with realtors and sellers. He then drove to Austria for a five-day vacation before returning home. Teddy *would not* have made the trip except for the business he conducted in Munich.

Teddy's travel outside the U.S., including two days of travel, totaled nine days. He does not meet either the one-week or less-than-25% nonbusiness test. Further assume he cannot establish that he had no substantial control over arranging the trip, or that a personal vacation was not a major consideration in making the trip. Thus, he does not qualify for any of the safe harbor tests. Teddy's travel expenses are subject to allocation between business and personal. Under the allocation rules, $^4/_9$ (four business days including the flight days out of a total of nine days outside the U.S.) of his expenses from Phila to Munich that were attributable to transportation and food (subject to the 50% disallowance unless provided by restaurants) and that would have been incurred had he returned from Munich to Philadelphia are deductible business expenses.

Attending Conventions outside North America

In addition to showing that a convention, seminar, or similar meeting ("convention") directly relates to the active conduct of their trade or business, taxpayers attending such meetings either outside the North American area or aboard a cruise ship must pass additional hurdles before claiming tax deductions for the related expenses [IRC Sec. 274(h)]. The North American area includes the U.S., its possessions, the Pacific Islands Trust Territory, Canada, Mexico, and certain Caribbean countries. (Rev. Rul. 2016-16 contains a list of the specific countries.)

To deduct expenses of attending a business convention outside North America, the taxpayer must establish that it is as reasonable for the meeting to be held outside the area as within the area. This reasonableness test considers such factors as—

1. the purpose and activities of the meeting,
2. the sponsoring organization,
3. the residences of the organization's active members, and
4. the location of other meetings [IRC Sec. 274(h)(1)].

In addition, the time spent in business meetings or activities must be substantial when compared to that spent sightseeing and engaged in other personal activities; otherwise, the travel is deemed to be a personal vacation and only the meeting registration fees and other direct business costs are deductible (Rev. Rul. 79-425).

> **NOTE:** Only business-related conventions and seminars can generate deductions for travel expenses. No travel expense deductions are allowed for attending conventions or seminars (within or outside the U.S.) that are investment related (e.g., financial planning seminars for investors) [IRC Sec. 274(h)(7)].

Conventions on Cruise Ships

Deductions related to conventions held aboard cruise ships are limited to $2,000 per individual per calendar year [IRC Sec. 274(h)(2)]. In addition, deductions are available only if the ship is a U.S.-registered vessel, and all its ports of call are in the U.S. or its possessions. A taxpayer must also attach the following written information statements to his return in the year a deduction is claimed [IRC Sec. 274(h)(5)]:

1. A statement signed by the taxpayer showing the total days of the trip (excluding travel to and from the ship), the number of hours each day spent attending scheduled business activities, and the program of the convention's scheduled business activities.
2. A statement signed by an officer of the sponsoring organization that includes a schedule of each day's business activities and the number of hours the taxpayer attended those activities.

Luxury Water Travel

The deductible amount of business travel by ocean liner, cruise ship, or other form of luxury water transportation is limited to twice the highest federal per diem rate allowable at the time the business travel takes place [IRC Sec. 274(m)(1)]. However, this rule does not apply to expenses allocable to a convention held on cruise ships (see previous discussion). If the cost of the travel includes a separately stated amount for meals, those expenses are limited before application of this per diem limitation. If meal expenses are not stated separately, the taxpayer *is not* required to allocate part of the cost (IRS Notice 87-23).

SUBSTANTIATION REQUIREMENTS

The Section 274(d) substantiation rules apply to travel, including meals and lodging while away from home (overnight or long enough to require rest and sleep), meals; and entertainment.

These rules disallow a deduction unless the taxpayer substantiates the following items by maintaining adequate records or by providing other sufficient corroborating evidence:

Evidence Needed	Travel	Meals
Amount of the expense	X	X
Time and place	X	X
Business purpose	X	X
Business Relationship	NA	X

NOTE: Even though there may be no question as to the deductibility of an expense under IRC Sec. 162 or 212, the expense may be disallowed for lack of documentation to properly substantiate the expense (Reg. §1.274-1). A reasonable estimate of expenses incurred based on statistical data and hours worked will not suffice unless there is explicit guidance permitting the use of such deemed substantiation (Rev. Rul. 2005-52).

NOTE: The Cohan doctrine, which enables taxpayers to estimate business expenses when evidence indicates such expenses were incurred (but an exact amount cannot be determined), cannot be used for expenses for travel, business gifts, or the use of listed property (e.g., cars) [Temp. Reg. §1.274-5T(a)].

Adequate Records

To meet the adequate records requirement of IRC Sec. 274(d), a taxpayer shall maintain—

1. an account book, diary, log, statement of expense, trip sheets, or similar record; and
2. documentary evidence that, in combination, are sufficient to establish each element of an expenditure or use for travel or entertainment [Temp. Reg. §1.274-5T(c)(2)(i)].

However, it is not necessary to record information in an account book, diary, log, statement of expense, trip sheet, or similar record which duplicates information reflected on a receipt so long as the account book, etc. and receipt complement each other in an orderly manner.

Documentary Evidence

Documentary evidence (paid bill, written receipt, or similar evidence) is required to substantiate all expenses of $75 or more. A written receipt is always required for lodging while traveling away from home, regardless of the amount. However, for transportation charges, documentary evidence is not required if not readily available (e.g., cab fare) [Reg. §1.274-5(c)(2)(iii)].

CAUTION: A credit card statement is not sufficient documentary evidence of a lodging expense. Instead, a hotel bill showing the components of the hotel charge is required [Reg. §1.274-5(c)(2)(iii)].

The IRS has privately ruled that the essential element of the documentary evidence requirement of a travel expense is that it establishes the appropriate data (i.e., amount, date, place, and business purpose). The IRS believes this does not require an original document, such as an airline ticket receipt, and does not prohibit faxes or copies.

PER DIEM METHOD OF SUBSTANTIATING

A taxpayer may use a per diem method of substantiation in lieu of accounting for and deducting the actual amount of travel costs. Per diems can be used to substantiate travel cost; the time, place, and business purpose must still be substantiated through adequate documentation. The per diem method is available to—

1. employers for use with an employee reimbursement plan,
2. employees not covered by an accountable or other expense allowance arrangement, and
3. self-employed individuals. (Self-employed individuals can use the optional per diem method only for deducting meals and incidental expenses, not for lodging.)

See Gear Up's *Business Entities* manual for a more detailed discussion of travel per diems.

Travel Per Diem Rates	**2021**	**2020**	**2019**
M&IE only	$60	$60	$60
Incidental expenses (IE) only —CONUS or OCONUS	$5	$5	$5
Transportation Workers—special M&IE per diem rate			
CONUS	$66	$66	$66
OCONUS	$71	$71	$71
Source:	*Notice 2020-71*	*Notice 2019-55*	*Notice 2018-77*

WHERE TO GO FOR FURTHER INFORMATION

- Checkpoint's Federal Tax Compliance Library
  - *PPC's 1040 Deskbook*
- Checkpoint's Tax and Financial Planning Library
  - *PPC's Guide to Self Employed Individuals*
  - *PPC's Guide to Tax Planning for High Income Individuals*
- IRS Publication 463: *Travel, Gift, and Car Expenses*

CHAPTER 25: EXCESS BUSINESS AND NET OPERATING LOSSES

Learning Objectives

Completion of this chapter will enable participants to—

- Analyze what tax years are retroactively exempt from IRC Sec. 461(l)'s loss limitation rules for noncorporate taxpayers.
- Identify CARES Act impact on individual taxpayers' net operating losses.
- Calculate the net operating loss of an individual taxpayer.

WHAT'S NEW

- TCJA changes are now effective for 2021.

EXCESS BUSINESS LOSSES

The TCJA provided that for tax years beginning after December 31, 2017, and before January 1, 2026, excess business losses of a taxpayer other than a corporation were not allowed for the tax year [IRC Sec. 461(l)(1)].

NOTE: CARES Act §2304, temporarily modified the loss limitation for noncorporate taxpayers so they can deduct excess business losses arising in 2018, 2019, and 2020 [IRC Sec. 461(l)(1)].

The excess farm loss rules of IRC Sec. 461(j) were suspended for any taxable year beginning after December 31, 2017 and before January 1, 2026.

Note that this provision does not change the applicability of other loss limitation rules that may apply (e.g., basis or passive activity loss rules).

An excess business loss is the excess (if any) of the taxpayer's aggregate deductions for the tax year that are attributable to trades or businesses of the taxpayer over the sum of—

1. The taxpayer's aggregate gross income or gain for the tax year, which is attributable to those trades or businesses, plus
2. Original amounts: $250,000 [200% of that amount for a MFJ return (i.e., $500,000)].
3. For 2021, the amounts are 262,000 [200% of that amount for a MFJ return (i.e., $524,000)].

The thresholds are subject to inflation adjustments.

NOTE: In determining whether a taxpayer has an excess business loss, IRC Sec. 461(l) applies to the aggregate income and deductions from all of a taxpayer's trades or businesses.

If spouses have separate trades or businesses and file a joint return, IRC Sec. 461(l) applies to the aggregate income and deductions from all of both spouse's trades or businesses.

The practical result of IRC Sec. 461(l) is that the business losses of a non-corporate taxpayer can offset no more than $524,000 (for married individuals filing jointly), or $262,000 (for other individuals), of a taxpayer's non-business income for that year. Note that if married taxpayers file a joint return, the losses (up to the $524,000 limit) of one spouse can also be used to offset the other spouse's non-business income.

NEW DEVELOPMENTS: The CARES Act made several technical corrections to the TJCA, including clarifying that—

- For any taxable year beginning after 2020 and before 2026, any excess business loss of a taxpayer other than a corporation is not allowed for the taxable year, and any excess business loss not allowed is carried forward and treated as part of the taxpayer's NOL carryover. The excess business loss now converted to a NOL for the taxable year is then carried over to subsequent taxable years under the applicable NOL carryover rules.

- The aggregate business deductions taken into account to determine the excess business loss of the taxpayer for the taxable year that is attributable to trades or businesses of the taxpayer are determined without regard to any deduction under IRC Sec. 172 (relating to NOLs) or IRC Sec. 199A (relating to the deduction for qualified business income).

- As capital losses cannot offset ordinary income under the NOL rules, any capital loss deductions are not taken into account in computing the Section 461(l) limitation.

- The amount of capital gain taken into account in calculating the Section 461(l) limitation cannot exceed the lesser of capital gain net income from a trade or business or capital gain net income.

- And in perhaps the most important technical correction, the CARES Act clarifies that the Section 461(l) excess loss is determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee. Form W-2 wage income is not part of the excess business loss calculation for 2021 and going forward..

EXAMPLE: Treatment of wage income of one spouse when calculating the other spouse's business loss deduction

Assume married taxpayers filing jointly for the 2022 taxable year have a loss from a trade or business conducted by one spouse as a sole proprietorship, as well as wage income of the other spouse from employment. The wage income *will not* be taken into account in determining the amount of the deduction limited under IRC Sec. 461(l). For tax years 2018 and 2019, there was some confusion regarding the interplay of wage income and the Section 461(l) limitation as, contrary to Congressional intent, IRS Form 461, Limitation on Business Losses (and its instructions), included wages and salaries (amounts from the trade or business of being an employee) in the determination of the taxpayer's excess business loss amount.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder (owner) level. Each owner's share of an entity's items of income, gain, deduction, or loss is taken into account in applying the owner's limit on excess business losses for the tax year.

Only the trades or businesses of the taxpayer are considered for purposes of the

Section 461(l) Limitation

To be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

As clarified by the CARES Act, any loss that is disallowed as an excess business loss is treated as a net operating loss (NOL) carryover to the following tax year under IRC Sec. 172. Thus, excess business losses are carried forward and treated as part of the taxpayer's NOL carryforward in later tax years.

PLANNING TIP: The Section 461(l) limitation was removed retroactively for tax years 2018, 2019 and 2021. Practitioners should review their client files to identify any taxpayers subject to the Section 461(l) limitation for either (or both) tax years and amend the impacted personal income tax returns.

EXAMPLE: Amending returns for taxpayers subject to the Section 461(l) limitation

For 2018, Harold and Maude filed a joint return on which they reported a $800,000 loss from their business on Schedule C (Form 1040). Harold also received Form W-2 income for 2018 of $925,000. Consistent with Congressional intent (and the Joint Committee on Taxation's explanation of the TCJA), their tax practitioner did not include Harold's wages in the Section 461(l) limitation calculation. Assume the business loss is otherwise allowable under IRC Sec(s). 465 and 469 (at-risk basis and passive activity loss limitation, respectively).

After application of the $500,000 threshold amount for joint filers, the remaining $300,000 business loss was an excess business loss and was not allowed for Harold and Maude's taxable year 2018. Instead, Harold and Maude had a $300,000 NOL eligible for carryover to 2019.

With the CARES Act's retroactive removal of the Section 461(l) limitation for tax years 2018, 2019, and 2020, Harold and Maude's 2018 personal income tax returns must be amended to reflect the entire $800,000 Schedule C loss as allowable.

Harold and Maude may also have to amend their 2019 personal income tax returns. To the extent that their 2019 taxable income reflected any of the now non-existent 2018 NOL carryforward, the couple's 2019 taxable income is now understated.

NOTE: IRC Sec. 461(l) applies after the application of the passive loss rules of IRC Sec. 469.

NET OPERATING LOSSES

Legislative Impacts

The TCJA made a number of changes with respect to losses arising in taxable years beginning after December 31, 2017:

1. First, the provision limited the NOL deduction to 80 percent of taxable income (determined without regard to the NOL deduction).

> **PLANNING TIP:** In calculating the amount of the NOL arising in a taxable year, certain deductions are excluded (e.g., the QBI deduction under IRC Sec. 199A).

2. Carryovers of these NOLs to subsequent tax years may be carried over indefinitely.

3. In addition, the TCJA repealed the two-year carryback and the special carryback provisions for individual casualty losses, and small business and farming disaster losses.

4. In the case of certain farming losses, the provision shortened the carryback period from five years to two years.

> **PLANNING TIP:** NOLs arising in taxable years beginning before January 1, 2018, remain subject to pre-TCJA (and pre-CARES Act) law. Accordingly, such NOLs are not subject to the 80% limitation and remain subject to the 20-year carryover limitation and to the prior-law carryback rules.

Section 2303 of the 2020 CARES Act temporarily suspended the 80% taxable income limitation to allow a net operating loss (NOL) to fully offset taxable income [IRC Sec. 172(a)] for taxable years beginning after December 31, 2017, and before January 1, 2021. However, the 80% taxable income limit continues to apply—

1. in any tax year beginning after December 31, 2020, and

2. with respect to any NOLs arising in taxable years beginning after December 31, 2017, carried to any tax year beginning after December 31, 2020.

The CARES Act provision clarifies that the 80% taxable income limitation is calculated without regard to the deductions allowable under IRC Sec(s). 172 (NOL), 199A (QBI), and 250 (GILTI).

CARES Act §2303 also modifies the rules relating to NOLs arising in 2018, 2019, and 2020. The provision provides that any NOL arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, may be carried back to each of the five taxable years preceding the taxpayer year of loss. Farming losses (generally subject to a two-year carryback period) may also be carried back five years under this provision.

> **PLANNING TIP and REMINDER:** Pursuant to IRC Sec. 172(b)(2), any NOL carryback must be carried to the earliest taxable years to which the loss may be carried.

CARES Act §2303 provides special rules relating to NOL carrybacks to years to which IRC Sec. 965 (the deemed *repatriation transition tax*) applies.

If a NOL of a taxpayer is carried to a taxable year in which the taxpayer included an amount in income by reason of IRC Sec. 965(a) (i.e., 2017, 2018, or both), the taxpayer may elect to exclude IRC Sec. 965(a) inclusion years from the five-year carryback period. This election does not extend the five-year carryback period; instead, a taxpayer making this election is permitted to use the NOL in a subsequent year within the five-year carryback period in which the taxpayer has taxable income.

If a taxpayer *does no*t elect to exclude its IRC Sec. 965(a) inclusion year(s) from the five-year carryback period and a NOL of the taxpayer arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, is carried to such year(s), then the taxpayer is treated as having made an election under IRC Sec. 965(n) not to apply any NOL deduction to the taxpayer's IRC Sec. 965(a) inclusion amount (net of the IRC Sec. 965(c) deduction) with respect to such taxable years.

PLANNING TIP: IRC Sec. 965(n) and Reg. §1.965-7(e) allow a taxpayer to make an election to not take into account Section 965(a) inclusions when determining the taxpayer's NOL deduction under IRC Sec. 172 for the tax year, or the taxable income for the tax year that may be reduced by NOL carryovers or carrybacks to the tax year under IRC Sec. 172.

EXAMPLE: Treatment of a NOL

In 2020, a calendar-year taxpayer has a $120,000 loss. The taxpayer may carry the $120,000 NOL from 2020 to the five taxable years preceding the taxable year of such loss.

For an NOL arising in 2020, the relevant taxable years within the relevant five-year carryback period are 2015, 2016, 2017, 2018, and 2019.

If the taxpayer had $20,000 of taxable income in 2015 and $30,000 of taxable income in 2016 (both without regard to any NOL deduction), then the taxpayer is entitled to a $20,000 NOL deduction in 2015 and a $30,000 NOL deduction in 2016.

The remaining unused portion of the 2020 NOL is $70,000.

Assume that in 2017, the taxpayer had a Section 965(a) inclusion [net of the Section 965(c) deduction], which the taxpayer elected to pay in installments, and other taxable income (before any NOL deduction). The taxpayer would have two options:

- Apply the default rule and carry the NOL to 2017, or
- Elect to exclude 2017 [the taxpayer's Section 965(a) inclusion year] from the five-year carryback period (i.e., carry back the 2020 NOL only to 2015, 2016, 2018, and 2019, before carrying forward).

These special rules allow taxpayers to use NOLs to a greater extent to offset taxable income in prior or future years in order to provide taxpayers with liquidity in the form of tax refunds and reduced current and future tax liability. For example, the election to exclude IRC Sec. 965(a) inclusion years from the five-year carryback period allows taxpayers with an outstanding IRC Sec. 965 tax liability to use NOLs in another year such that any resulting overpayment would result in an authorized refund rather than offset the outstanding IRC Sec. 965 tax liability.

Both the Section 965(a) election and the election to waive the entire carryback period with respect to a NOL arising in a taxable year beginning in 2018 or 2019, are required to be made by the due date (including valid extension) for filing the taxpayer's return for the first taxable year ending after the date of the CARES Act enactment (namely, March 27, 2020).

NEW DEVELOPMENT: In Notice 2020-26, the Department of the Treasury and the IRS granted a six-month extension of time to file Form 1045 for taxpayers that have a NOL that arose during calendar year 2018. Notice 2020-23 further extended the deadline.

For example, in the case of a NOL that arose in a taxable year ending on December 31, 2018, a taxpayer normally would have until December 31, 2019, to file the Form 1045. The 2020 relief extended the refund application date to July 15, 2020 (Notice 2020-23).

For taxpayers that missed the Form 1045 filing deadline (for 2018 calendar tax years), they can still carryback NOLs but now must do so by filing a Form 1040X for the affected tax year.

Rev. Proc. 2020-24 provides the "how to" guidance to implement the elections related to IRC Sec. 172(b)(1)(D), as added by the CARES Act. The guidance applies to taxpayers that want to:

1. Elect under IRC Sec. 172(b)(3) to waive the carryback period for a NOL arising in a taxable year beginning in 2018 or 2019, or

2. Elect under IRC Sec. 172(b)(1)(D)(v)(I) to exclude all IRC Sec. 965 years from the carryback period for a NOL arising in a taxable year that begins in 2018, 2019, or 2020.

For taxpayers electing under IRC Sec. 172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019:

1. The election must be made no later than the due date (including extensions) for filing the taxpayer's federal income tax return for the first taxable year ending after March 27, 2020.

2. A taxpayer must make this election by attaching to its federal income tax return filed for the first taxable year ending after March 27, 2020, a separate statement for each of taxable years 2018 or 2019 for which the taxpayer intends to make the election.

3. The election statement must state that the taxpayer is electing to apply IRC Sec. 172(b)(3) under Rev. Proc. 2020-24 and the taxable year for which the statement applies.

Once made, the election is irrevocable.

Taxpayers electing under IRC Sec. 172(b)(1)(D)(v)(I) to exclude all Section 965 years from the carryback period for a NOL arising in a taxable year that begins in 2018, 2019, or 2020, must also do so by the due date (including extensions) for filing the taxpayer's federal income tax return for the first taxable year ending after March 27, 2020.

PLANNING TIP: For more information on the election to exclude all Section 965 years from the carryback period, see Rev. Proc. 2020-24, Section 4.01(2).

Calculation

The term *net operating loss* means the excess of the deductions allowed by IRC Sec. 172 over the taxpayer's gross income [IRC Sec. 172(c)].

PLANNING TIP: Because of the way NOLs are computed, two important points must be remembered when determining whether a taxpayer has incurred an NOL. Negative taxable income does not always result in an NOL. Also, an NOL may exist even if there is positive adjusted gross income (AGI).

The following items are deductible for purposes of taxable income, but not for the NOL computation. They must be added back to negative taxable income when computing the NOL generated in a tax year [IRC Sec. 172(d); Reg. §1.172-3]:

1. Personal exemptions (reduced to zero for years 2018–2025).
2. NOL carryover from another year.
3. Excess of nonbusiness capital losses over nonbusiness capital gains.
4. Section 1202 exclusion (i.e., the exclusion for 50%–100% of the gain realized on the sale of qualified small business stock).
5. Excess of nonbusiness deductions over nonbusiness income.
6. Excess of business capital losses over the total of—
    a. Business capital gains, and
    b. Any nonbusiness capital gains remaining after reducing for nonbusiness capital losses and other nonbusiness deductions (i.e., the taxpayer cannot take a deduction for a net capital loss when computing the NOL) [Reg. §1.172-3(a)(2)(i)].

NOTE: A net Section 1231 loss is treated as an ordinary business loss and is thus included in the NOL [Reg. §1.172-3(a)(3)(ii)].

However, Section 1231 gains may not offset the excess of nonbusiness capital losses over nonbusiness capital gains. Nonbusiness capital losses are not considered when computing NOL.

EXAMPLE: Treatment of nonbusiness capital loss when calculating NOL

Maya has a net Section 1231 gain of $100,000 and a nonbusiness capital loss of $70,000. Maya must add her $100,000 of Section 1231 gain back to the NOL computation (thus, reducing the NOL), whereas the nonbusiness capital loss of $70,000 would be disregarded.

Maya’s Section 1231 gain of $100,000 and the nonbusiness capital loss of $70,000 cannot be combined for NOL purposes. The nonbusiness capital loss is unused for NOL purposes.

7. Any qualified business income deduction computed under IRC Sec. 199A, including the deduction for specified agricultural or horticultural cooperatives under IRC Sec. 199A(g).
8. The deduction under IRC Sec. 250 (foreign-derived intangible income and global intangible low-taxed income).

Nonbusiness income includes the following:

1. Investment income (e.g., dividends, interest).

2. Nonbusiness capital gains in excess of nonbusiness capital losses.
3. Annuities.
4. Oil and gas royalties.

Nonbusiness deductions include the following (not an all-inclusive list):

1. Alimony payments.
2. IRA contributions.
3. Contributions to a personal retirement plan (e.g., Keogh, SEP, or SIMPLE IRA) by a self-employed person.
4. Student loan interest deduction.
5. Tuition and fees deduction.
6. Archer MSA deduction.
7. Health Savings Account (HSA) deduction.
8. Nonbusiness itemized deductions, including medical expenses, taxes, interest, and charitable contributions (does not include casualty or theft losses attributable to a federally declared disaster or Ponzi-type investment losses), state income tax on trade and business income, or unreimbursed employee business expenses (temporarily suspended for years 2018–2025).
9. The standard deduction for taxpayers who do not itemize.
10. Other nonbusiness deductions as determined by the IRS.

Special Rules

In the case of certain farming losses, the TCJA shortened the NOL carryback period from five years to two years.

> **NOTE:** The term *farming business* is defined in IRC Sec. 263A(e)(4) for purposes of the uniform capitalization (UNICAP) rules [IRC Sec. 172(b)(1)(B)(ii)(I)] as follows:
>
> > *Farming business* shall include the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (an evergreen tree which is more than six years old at the time severed from the roots shall not be treated as an ornamental tree).

Unless elected otherwise, a NOL is carried back first to the second tax year proceeding the loss year.

In applying IRC Sec. 172(b)(2), which provides the order in which NOLs are absorbed, a farming loss for any tax year is treated as a separate NOL for that tax year and is considered after the remaining part of that year's NOL [IRC Sec. 172(b)(1)(B)(iii)].

A taxpayer entitled to a two-year carryback of a farming loss may elect to forego the carryback. The election is made by attaching a statement to the return stating that the taxpayer elects to forgo the two-year carryback period (IRS Pub. 536). An election is irrevocable for the tax year for which it was made [IRC Sec. 172(b)(1)(B)(iv)].

Alternatively, farming losses may be carried back five years under CARES Act §2303.

> **PLANNING TIP:** Pursuant to IRC Sec. 172(b)(2), absent an election out of the carryback rules, any NOL carryback must be carried to the earliest taxable years to which the loss may be carried. For farming losses that would be earliest of a two- or five-year carryback period.

A five-step process is used to compute a taxpayer's refund from the carryover or carryback of a farming NOL generated in a year when the taxpayer was not married and carried to a year when the taxpayer was married (see IRS Pub. 536 for more information).

NOLs incurred in years the taxpayers were not married to each other can be applied only against the separate income of the spouse who generated the loss. In other words, a NOL sustained by one spouse before marriage cannot be carried over to offset the other spouse's income on a joint return; it can be applied only against the income of the spouse who incurred the loss [Calvin v. U.S., 16 AFTR 2d 6025 (CA10), 11/10/1965].

When married taxpayers generate a NOL carryover in a joint return year and subsequently file separate returns due to death or divorce, the treatment of the carryover depends on who generated the NOL. If it was generated by either one of the spouses separately, the carryover is available only to the taxpayer who generated it. If a NOL was generated by each spouse, the carryover must be allocated among the taxpayers on the basis of the NOL generated by each [Reg. §1.172-7(d)].

A surviving spouse can use a NOL carryover from a joint return year only to the extent it was generated by (or allocated to) the surviving spouse. Any NOL generated by (or allocated to) the deceased spouse that cannot be used on the decedent's final tax return expires; it is not available for use by the surviving spouse or by the decedent's estate (Rev. Rul. 74-175).

Reg. §1.172-7 provides guidance for taxpayers whose marital status remains the same during the NOL year and NOL carryover years. If the taxpayers file jointly for all of the years, the NOL is treated as if the taxpayers were one individual. If the taxpayers file separately for all of the years, the NOL is treated as if the taxpayers were two separate individuals, and the NOL for one spouse cannot offset any income of the other spouse. Special rules apply, however, when the taxpayers file jointly in some years and separately in others.

In community property states, the usual rules for computing separate taxable income of married taxpayers are—

1. Earned income of either spouse is divided 50/50,
2. Unearned income from separate property is either separate or community income, depending on the particular state's laws,
3. Deductions paid out of community property are allocated 50/50, and
4. Deductions paid out of separate property are allocated to the payer-spouse.

PLANNING TIP: The IRS has provided guidance for allocating refunds among spouses in the various community property states in Rev. Rul. 2004-71, 2004-72, 2004-73, and 2004-74.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 225, *Farmer's Tax Guide*
- IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*
- IRS FAQs about NOL carrybacks for taxpayers who have had Section 965 inclusions: **www.irs.gov/newsroom/frequently-asked-questions-about-carrybacks-of-nols-for-taxpayers-who-have-had-section-965-inclusions**
- IRS Form 1045, Application for Tentative Refund, and instructions

CHAPTER 26: COVID-19 PANDEMIC SUBSIDY PLANS

Learning Objectives

Completion of this chapter will enable participants to—

- Define key elements of the Paycheck Protection Program (PPP), relating to income recognition, deductions and basis.
- Describe the key payroll provisions of the Emergency Paid Sick Leave Act (EPSLA) and the Emergency Family and Medical Leave Expansion Act (EFMLEA).
- Discuss the COBRA Premium Assistance Credit
- Explain the Employer Retention Credit

PAYCHECK PROTECTION PROGRAM (PPP)

Overview

In 2020, the CARES Act added the Paycheck Protection Program (PPP), to the SBA's 7(a) loan program. CARES Act Section 1106 provides for forgiveness of up to the full principal amount of qualifying loans guaranteed under the PPP. The PPP was intended to provide economic relief to small businesses nationwide adversely impacted by the ongoing pandemic. Subsequent legislation extended and modified the PPP, ultimately extending the lending program through May 31, 2021.

A borrower can apply for forgiveness once all loan proceeds for which the borrower is requesting forgiveness have been used. Generally, both first and second draw PPP loans made to eligible borrowers qualify for full loan forgiveness if during the 8- to 24-week covered period following loan disbursement:

- Employee and compensation levels are maintained,
- The loan proceeds are spent on payroll costs and other eligible expenses, and
- At least 60% of the proceeds are spent on payroll costs.

Borrowers can apply for forgiveness any time up to the maturity date of the loan. If borrowers do not apply for forgiveness within 10 months after the last day of the covered period, then PPP loan payments are no longer deferred, and borrowers must begin making loan payments to their PPP lender.

PPP LOANS—FIRST or SECOND DRAW	
INCOME	No amount shall be included in the gross income of the eligible recipient or entity by reason of forgiveness of indebtedness.
DEDUCTIONS	No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied (by reason of the gross income exclusion).
BASIS	In the case of an eligible entity that is a partnership or S corporation, any amount excluded from income shall be treated as tax-exempt income for purposes of IRC Secs. 705 and 1366. Any related increase in the adjusted basis of a partner's interest in a partnership under IRC Sec. 705 shall equal the partner's distributive share of deductions resulting from costs giving rise to loan forgiveness.
2021 Act, Division N, Title II, Subtitle B (COVID-related Tax Relief Act of 2020), Sec. 276	

Income—PPP Loan Forgiveness

The reduction or cancellation of indebtedness generally results in cancellation of debt income to the debtor. However, for federal income tax purposes, PPP (first and/or second draw) loan forgiveness is not includible in the gross income of the recipient. The CARES Act provides that any amount that would otherwise be includible in gross income of the recipient by reason of forgiveness described in section 1106(b) "shall be excluded from gross income."

The CARES Act language operates to exclude from the gross income of a recipient any category of income that may arise from covered loan forgiveness, regardless of whether such income would be (a) properly characterized as income from the discharge of indebtedness under IRC Sec. 61(a)(11), or (b) otherwise includible in gross income under IRC Sec. 61.

Deductions—PPP

The CARES Act was silent on the deductibility of expenses paid with forgiven PPP loan proceeds.

In April 2020, the IRS issued Notice 2020-32. The notice explained that no deduction was allowed for federal tax purposes for an otherwise deductible expense if the payment of the expense resulted in forgiveness of a PPP covered loan and the income associated with the forgiveness was excluded from gross income pursuant to the CARES Act.

In November 2020, the IRS issued Rev. Rul. 2020-27. In this ruling, the IRS doubled down by concluding that the taxpayer could not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expected to receive forgiveness of the covered loan on the basis of the expenses it paid or accrued during the covered period, even if the taxpayer had not submitted an application for forgiveness of the covered loan by the end of such taxable year.

Throughout 2020, Congress insisted it had intended for PPP borrowers to attain a double tax benefit by allowing them to claim deductions otherwise allowable, even though paid with tax-exempt income. At long last, on December 27, 2020, the COVID-related Tax Relief Act of 2020 was passed, codifying this intention for all PPP loans as if the language had been originally included in the CARES Act. As a result, for otherwise allowable expenses, no deduction is denied a taxpayer simply because of the gross income exclusion provided for the forgiven PPP loan proceeds. In response, the IRS issued Rev. Rul. 2021-1, obsoleting Notice 2020-32 and Rev. Rul. 2020-27.

General federal tax principles will determine what expenses are deductible and when the deductions are allowed (e.g., cash-basis taxpayers generally deduct expenses when paid).

Deductions—PPP Safe Harbor

Rev. Proc. 2021-20 provides a safe harbor for certain taxpayers that received a PPP loan and due to the now obsoleted guidance, did not deduct certain otherwise deductible expenses paid or incurred during the taxpayer's taxable year(s) ending after March 26, 2020, and on or before December 31, 2020, that resulted in, or were expected to result in, forgiveness of the loan. The revenue procedure refers to this taxable year (or years) as the *2020 taxable year*.

Under the safe harbor, such taxpayers can elect to deduct these expenses on the taxpayer's timely filed original Federal income tax return or information return, as applicable, for the taxpayer's first taxable year following the taxpayer's 2020 taxable year rather than filing an amended return or administrative adjustment request for the taxpayer's 2020 taxable year.

A taxpayer must be a *covered taxpayer* to use the safe harbor rules of Rev. Proc. 2021-20. A *covered taxpayer* is a taxpayer that satisfies all the following:

1. The taxpayer received an original PPP covered loan (note that this does not include second draw PPP loans);

2. The taxpayer paid or incurred original eligible expenses during the taxpayer's 2020 taxable year;

3. On or before December 27, 2020, the taxpayer timely filed, including extensions, a federal income tax return or information return, as applicable, for the taxpayer's 2020 taxable year; and

4. On the taxpayer's Federal income tax return or information return, as applicable, the taxpayer did not deduct the original eligible expenses because (a) the expenses resulted in forgiveness of the original PPP covered loan; or (b) the taxpayer reasonably expected at the end of the 2020 taxable year that the expenses would result in such forgiveness.

For more information on making a valid election, see Gear Up's *Business Entities* manual.

Basis—PPP Loan Forgiveness

In the case of a partnership or S corporation borrower, the PPP loan forgiveness excluded from income is treated as tax-exempt income for purposes of IRC Sec(s). 705, Determination of Basis of a Partner's Interest, and 1366, Pass-Through of Items to Shareholders.

Except in very limited circumstances (e.g., a qualifying disposition of S corporation stock), shareholders of an S corporation will be allocated the tax-exempt income and related deductions on a per share, per day basis.

Any related increase in the adjusted basis of a partner's interest in a partnership under IRC Sec. 705 shall equal the partner's distributive share of deductions resulting from costs giving rise to loan forgiveness.

	S Corporation Shareholder	Partner
Tax-exempt income—PPP loan forgiveness	Increases basis under IRC Sec. 1366	Increases basis under IRC Sec. 705
Related deductions	Decreases basis under IRC Sec. 1366	Decreases basis under IRC Sec. 705

Unfortunately, neither the legislation nor IRS have addressed the proper timing of the basis increase resulting from the PPP loan forgiveness (tax-exempt income).

EXAMPLE: Treatment of PPP induced increase in basis when incurring an overall loss

Afloat, Inc. (an S corporation) receives a PPP loan of $400,000 in 2020 and incurs an overall loss of $720,000 in its calendar 2020 tax year, passing that loss through to its 100% shareholder, Barney. The PPP loan is not forgiven until 2021.

At the beginning of 2020, Barney had no stock or debt basis.

Assuming no other adjustments to Barney's stock basis, he is allocated a 2020 tax loss of $720,000, but is not able to utilize the loss on his 2020 personal income tax return due to inadequate basis in Afloat, Inc.

The loss would be suspended until Barney has enough basis to utilize the loss.

Under general tax principles, debt cancellation income is recognized when the lender has absolved the borrower from any future repayment of that portion of the debt. Debt is considered cancelled or discharged at the moment that it becomes clear that the debt will never have to be paid.

In the absence of IRS guidance to the contrary, it is likely reasonable to conclude that the tax-exempt income and resulting basis increase take place in the tax year that the PPP loan is formally forgiven.

LEAVE CREDITS OVERVIEW

The Families First Coronavirus Response Act (FFCRA), which was intended to ease the economic consequences stemming from the novel coronavirus disease (COVID-19) outbreak, required employers to provide family leave and sick leave to employees and provided tax credits to employers for providing the leave.

The Consolidated Appropriations Act, 2021 (CAA) was then enacted to provide further emergency assistance for individuals, families, and businesses affected by the COVID-19 pandemic. Under the CAA, eligible employers may claim the FFCRA credits for qualified paid leave that took place on or before March 31, 2021.

On March 11, 2021, the president signed into law the American Rescue Plan Act of 2021 (ARPA). This round of economic stimulus builds on earlier pandemic relief and extends the FFCRA credits for qualified paid leave through September 30, 2021. The ARPA creates:

- IRC Sec. 3131 (Credit for Paid Sick Leave),

- IRC Sec. 3132 (Payroll Credit for Paid Family Leave), and
- IRC Sec. 3133 (Special Rule Related to Tax on Employers).

The incentives are payroll tax credits, claimed on an employer's federal payroll tax form:

- Form 941 (Employer's QUARTERLY Federal Tax Return, or
- Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees), or
- Form 944 (Employer's ANNUAL Federal Tax Return) or
- Form 1040, Schedule H (Household Employment Taxes).

COBRA PREMIUM ASSISTANCE CREDIT

Overview

ARPA provides for a temporary 100% reduction in the premium otherwise payable by certain individuals and their families who elect COBRA continuation coverage due to a loss of coverage as the result of a reduction in hours or an involuntary termination of employment. The temporary premium assistance is also available to individuals enrolled in continuation health coverage under State programs that provide for coverage comparable to COBRA continuation coverage, often referred to as "mini-COBRA."

COBRA premium assistance is available as of the first period of coverage beginning on or after April 1, 2021 and will not be available for periods of coverage beginning after September 30, 2021.

The person to whom premiums for COBRA continuation coverage are payable (the employer, insurer, or multiemployer plan, as applicable) is entitled to a refundable tax credit against its share of Medicare taxes under newly added IRC Sec. 6432.

Notice 2021-31 provides guidance on the COBRA premium assistance credit in the form of 86 frequently asked questions and answers. On July 26, 2021, the IRS made 11 supplemental answers in Notice 2021-46 to the responses included in Notice 2021-31.

Assistance Eligible Individual (AEI)

The ARPA requires that health insurance issuers and group health plans treat Assistance Eligible Individuals as having paid the full amount of their COBRA premium for the specified coverage.

An Assistance Eligible Individual (AEI) is any individual who is:

1. A qualified beneficiary as the result of (a) the reduction of hours of a covered employee's employment or (b) the involuntary termination of a covered employee's employment (other than by reason of an employee's gross misconduct),
2. Is eligible for COBRA continuation coverage for some or all of the period beginning on April 1, 2021, through September 30, 2021, and
3. Elects the COBRA continuation coverage.

This includes qualified beneficiaries who are the spouse or dependent child of the employee who had the reduction in hours or involuntary termination of employment resulting in a loss of coverage, as well as the employee, if that reduction in hours or involuntary termination of employment caused the qualified beneficiary to lose coverage and the other requirements are satisfied.

ARPA provides an extended election period for certain individuals who did not have an election of COBRA continuation coverage in effect on April 1, 2021, referred to in Notice 2021-31 as the *ARP extended election period*.

The ARPA extended election period is available for an individual who would be an AEI if the individual had a COBRA continuation coverage election in effect on April 1, 2021, or an individual who previously elected COBRA continuation coverage and discontinued that coverage before April 1, 2021. The ARP extended election period continues for 60 days after these individuals are provided notice of the extended election period. The resulting COBRA continuation coverage does not extend beyond the maximum period of COBRA continuation coverage that would have been required under the applicable COBRA continuation coverage provision if the individual had elected COBRA continuation coverage initially as required under that applicable COBRA provision or had not discontinued the elected COBRA continuation coverage.

An AEI is entitled to receive COBRA premium assistance as of the first applicable period of coverage beginning on or after April 1, 2021. For this purpose, a period of coverage is a monthly or shorter period with respect to which premiums are normally charged by the plan or issuer with respect to such coverage provided to employees and qualified beneficiaries. The start date of the first period of coverage beginning on or after April 1, 2021, depends on the period with respect to which premiums would have been normally charged by the plan if the individual had paid the premium.

EXAMPLE: COBRA coverage period for AEI

Employer A's plan provides that employees and qualified beneficiaries pay premiums for health coverage, including COBRA continuation coverage, on a biweekly basis for a corresponding two-week period of coverage. For March 2021, the last two-week period of coverage is from March 28 through April 10, 2021, followed by a period of coverage from April 11 through April 24, 2021. COBRA premium assistance could apply with respect to the premium for the period of coverage beginning April 11, 2021.

Interaction with Other Tax Credits and Pandemic Relief Programs

- An eligible employer may not benefit from both the COBRA premium assistance credit and the paid leave tax credits with respect to the same qualified health plan costs.

- An eligible employer may not benefit from both the COBRA premium assistance credit and the employee retention tax credits (neither the original employee retention credit under the CARES Act, or under IRC Sec. 3134) with respect to the same qualified health plan costs.

Interaction with Employer's Income Tax Return

The employer's claim for the COBRA premium assistance credit affects their income tax returns, by requiring the payroll tax credit to be reported as gross income.

The employer credit amount claimed does not reduce an employer's deduction for the related health plan expenses.

Under IRC Sec. 6432(e), Continuation Coverage Premium Assistance, the gross income of the employer is increased by the credit claimed in the taxable year which includes the last day of the calendar quarter the credit is allowed.

Claiming the Credit and Refundability

The credit is refundable to the extent it exceeds the employer's applicable payroll tax and is claimed using Form 941 (revised form beginning Q2 2021) and/or Form 7200, *Advance Payment of Employer Credits Due to COVID-19* (revised April 2021). The employer must report the number of individuals receiving COBRA premium assistance on line 11f of Form 941 (or the designated line of its applicable federal employment tax return).

Notice 2021-24 provides employers relief from the failure to deposit penalty imposed by IRC Sec. 6656 for an employer's failure to timely deposit employment taxes to the extent that the amounts not deposited are equal to or less than the amount of refundable tax credit to which the employer is entitled under the ARPA.

IRC Sec. 6432(f) extends the statute of limitations for the assessment of any amount attributable to the credit to five years after the later of (1) the date on which the original return which includes the calendar quarter with respect to which the credit is determined is filed, or (2) the date on which that return is treated as filed under IRC Sec. 6501(b)(2).

EMPLOYEE RETENTION CREDIT (ERC) OVERVIEW

The CARES Act provides a refundable payroll tax credit for 50% of qualified wages (and allocable qualified health plan costs) paid by eligible employers to certain employees during the 2020 COVID-19 crisis. For 2020, the maximum amount of qualified wages (including allocable qualified health plan expenses) considered with respect to each employee for all calendar quarters in 2020 is $10,000; thus, the maximum credit for qualified wages (including allocable qualified health plan expenses) paid to any employee in 2020 is $5,000.

The CAA extended the credit eligibility period through June 30, 2021 and increases the applicable credit percentage to 70% for calendar quarters beginning after December 31, 2020. The legislation also adopted certain amendments and technical changes to the employee retention credit (ERC) that are retroactive to the enactment of the CARES Act.

In addition, ARPA creates IRC Sec. 3134, which among other things, extends the ERC from June 30, 2021, until December 31, 2021. The maximum credit for qualified wages (including allocable qualified health plan expenses) paid to an employee is $7,000 per calendar quarter in 2021 (for a total of $28,000). The credit applies to wages and allocable qualified health plan expenses paid (or incurred) after March 12, 2020 and before January 1, 2022. An eligible employer may elect to not consider qualified wages for purposes of the ERC (Notice 2021-20, FAQ 56).

For further information see Gear Up's *Business Entities* manual, Chapter 3.

RESTAURANT REVITALIZATION FUND

The American Rescue Plan Act of 2021 (ARPA) established the Restaurant Revitalization Fund (RRF) to provide funding to help restaurants and other eligible businesses keep their doors open. This program provides restaurants with funding equal to their pandemic-related revenue loss up to $10 million per business (applicant and any affiliated businesses) and no more than $5 million per physical location.

Recipients are not required to repay the funding as long as funds are used for eligible uses no later than March 11, 2023. If the business permanently closes, the covered period will end when the business permanently closes or on March 11, 2023, whichever occurs sooner.

Program awardees that are unable to use all Restaurant Revitalization funds on eligible expenses by the end of the covered period must return any unused funds to the government.

NOTE: The federal relief fund closed on June 30, 2021, after funds appropriated for the program were exhausted. According to the SBA's RRF Report, *Approvals through 6/30/2021*, just over 101,000 recipients received a total of more than $28 billion dollars, with an average grant size of $283,000. However, the SBA reports that restaurants submitted 278,304 RRF grant applications totaling more than $72 billion dollars, well in excess of the $28.6 billion appropriated for the program.

The *Restaurant Revitalization Fund Replenishment Act of 2021* would replenish the RRF with a $60 billion second round of relief for restaurants. At this time, the bill's future is uncertain.

SHUTTERED VENUE OPERATORS GRANT (SVOG)

The Shuttered Venue Operators Grant (SVOG) program was established by the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act, and amended by the ARPA. The program includes over $16 billion in grants to shuttered venues, to be administered by SBA's Office of Disaster Assistance.

Eligible entities may be live venue operators or promoters, theatrical producers, live performing arts organization operators, museum operators, motion picture theatre operators or owners, and talent representatives. Additionally, entities of these types owned by state or local governments (for example, museums or historic homes) are eligible to apply if the government-owned entity acts solely as a venue operator, museum, etc. and does not engage in other types of activities.

Eligible applicants may qualify for grants equal to 45% of their gross earned revenue, with the maximum amount available for a single grant award of $10 million.

Recipients who receive an SVOG in the initial phase will have one year from the date their awards are disbursed by the SBA to use grant funds to pay allowable items of cost incurred between March 1, 2020, and December 31, 2021. If an eligible entity later receives additional supplemental grant funding, they will instead have 18 months from the date their initial award was disbursed by the SBA to expend all their combined grant funds but can only use those funds to pay allowable costs incurred between March 1, 2020, and June 30, 2022. At the end of the applicable deadline, SVOG grantees must return all unexpended SVOG funds to the SBA.

NOTE: The ARPA revised the Economic Aid Act to provide that those businesses that received a PPP loan after December 27, 2020, are no longer ineligible for a SVOG under certain conditions.

Specifically, if a PPP borrower received a first draw or second draw PPP loan after December 27, 2020, the amount of any subsequently approved SVOG will be reduced by the amount of the first draw or second draw PPP loan.

However, if a PPP applicant is approved for an SVOG before SBA issues a loan number for the PPP loan, the applicant is ineligible for the PPP loan and acceptance of any PPP loan proceeds will be considered an unauthorized use.

WHERE TO GO FOR MORE INFORMATION

- Gear Up's *Business Entities* manual

CHAPTER 27: MISCLASSIFIED AND DUAL CLASSIFIED WORKERS

Learning Objectives

Completion of this chapter will enable participants to—

- Describe to taxpayers the importance of obtaining Form W-9.
- Identify issues clients may face with the classification of workers.
- Describe how to use Section 530 relief during an audit.
- Describe how to use the Voluntary Classification Settlement Program (VCSP)

WHAT'S NEW?

- A discussion of the rules of Form W-9 and backup withholding.

DYNAMEX OPERATIONS WEST, INC.

A 2018 court case has had serious implications for the "gig economy". The Supreme Court of California used a new "ABC test" for determination of whether a worker was an employee or subcontractor. To be independent, the Court found that—

(A) A worker must be free from control and direction of the hiring entity per contract terms and in fact,

(B) The work performed is outside of the usual course of the hiring entity's business (this has a huge implication for both the "gig economy" and "on-demand workers"), and

(C) The worker is "customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity."

As a result of the above case, delivery workers, Lyft and Uber drivers, and others are fighting in the courts regarding worker classification.

Although the *Dynamex* case's "ABC test" was cited by a California court, it should be assumed to be coming to other states next. It has already been adopted by several states, including New Jersey, Illinois, and Massachusetts in total and in part by many other states.

The ABC test, as it has become known, requires to be a non-employee requires that all three tests are "passed" by the worker to be qualified. Conversely, failure of any test will mean the worker is an employee. Most jurisdictions that have adopted the ABC test have done so as they find the test administratively expediate.

> **OBSERVATION:** Many saw the *Dynamex* case as a fatal stab in the heart of the gig economy, particularly after the California legislature codified the ABC test, (California Labor Code AB 5). In 2020, Proposition 22 was approved by the voters of California allowing "app-based" drivers to act as independent contractors. Proposition 22 was not a total victory for the "app-based" gig economy as Proposition 22 also provided for a health care subsidy, minimum earnings guarantee, compensation for vehicle expenses, and insurance to cover on-the-job injuries.

FORM W-9 REQUIREMENTS

The IRS was recently criticized by the Treasury Inspector General Tax Administration (TIGTA) for its failure to enforce the rules of backup withholding, costing the U.S Treasury around $22 billion annually.

What Is Backup Withholding?

There are situations when the payer is required to withhold income tax at the current rate of 24%. This 24% tax is taken from any future payments to ensure the IRS receives the tax due on this income.

This is known as Backup Withholding (BWH) and may be required—

1. Under the BWH-B program because you failed to provide a correct taxpayer identification number (TIN) to the payer for reporting on the required information return. A TIN can be either your social security number (SSN), employer identification number (EIN), or individual taxpayer identification number (ITIN); or

2. Under the BWH-C program because you failed to report or underreported interest and dividend income you received on your federal income tax return; or you failed to certify that you're not subject to BWH for underreporting of commissions, fees, or other payments for work performed as a non-employee.

The certification of the exemption from backup withholding is delivered to the payer of the non-employee compensation on Form W-9 or an approved substitute form.

EXAMPLE: Form W-9, Part II, exemption certification

Part II Certification

Under penalties of perjury, I certify that:

1. The number shown on this form is my correct taxpayer identification number (or I am waiting for a number to be issued to me); and
2. I am not subject to backup withholding because: (a) I am exempt from backup withholding, or (b) I have not been notified by the Internal Revenue Service (IRS) that I am subject to backup withholding as a result of a failure to report all interest or dividends, or (c) the IRS has notified me that I am no longer subject to backup withholding; and
3. I am a U.S. citizen or other U.S. person (defined below); and
4. The FATCA code(s) entered on this form (if any) indicating that I am exempt from FATCA reporting is correct.

Certification instructions. You must cross out item 2 above if you have been notified by the IRS that you are currently subject to backup withholding because you have failed to report all interest and dividends on your tax return. For real estate transactions, item 2 does not apply. For mortgage interest paid, acquisition or abandonment of secured property, cancellation of debt, contributions to an individual retirement arrangement (IRA), and generally, payments other than interest and dividends, you are not required to sign the certification, but you must provide your correct TIN. See the instructions for Part II, later.

In the event the payer fails to obtain a certification of exemption from backup withholding the payer is liable for backup withholding payments in the amount of 24% from any payments made.

EXAMPLE: Failure to obtain a certification of backup withholding exemption

A taxpayer hires Joe Smith to perform work for his trade or business. When the taxpayer hired and paid Joe ($50,000), he called him on the phone to obtain Joe's SSN and address but failed to obtain a certification of exemption from backup withholding. He remitted the entire $50,000 to Joe after the work was completed. The IRS later contacted the taxpayer with an inquiry regarding the lack of backup withholding from Joe. As the taxpayer was not able to produce a certification of exemption from backup withholding, IRS assessed the taxpayer $12,000 ($50,000 × 24%).

OBSERVATION: No payments should be made to any non-employee without receipt of Form W-9. Even if the certification or some other information is falsified on the Form W-9 the taxpayer will not be liable for such things as—

- Backup Withholding
- Incomplete or Incorrect 1099-NEC

WORKER CLASSIFICATIONS

Common Law Employees

NOTE: Compensated corporate officers are *employees* for federal income tax withholding [IRC Sec. 3401(c)] and are also employees for FICA and FUTA purposes [IRC Sec(s). 3121(d)(1), 3306(i)]. Controlling shareholders of a closely held corporation performing services as corporate officers who perform more than minor services or receive compensation are also employees. However, corporate officers who perform only nominal (or no) services and who do not receive compensation may not be employees. Directors are generally considered independent contractors and not employees.

IRS agents are instructed to examine all payments to officers, including amounts labeled as draws, loans, dividends, or other distributions to determine if they should be reclassified as wages.

Statutory Employees

Statutory employees are employees for FICA and Medicare withholding, but are not employees for income tax purposes. Form W-2 income is reported on a Schedule C along with related expenses. Net income on Schedule C is not treated as net earnings from self-employment.

IRC Sec. 3121(d)(3) defines a *statutory employee* as—

1. An agent-driver or commission-driver who distributes beverages (other than milk), meat, vegetables, fruits, bakery products, or who pick up and deliver laundry or dry cleaning,
2. A full-time life insurance salesperson,
3. A home worker who works on materials or goods furnished by an employer to the employer's specifications, and required to be returned, or
4. A traveling sales agent working full-time and selling to wholesalers, retailers, contractors, operators of hotels, restaurants, or other similar establishments, supplies or merchandise for resale.

COURT CASE: In *Fiedziuszko*, the Tax Court held that a semi-retired engineer who found most of his own work was a statutory employee.

> The Court concluded that, for both 2011 and 2012, Mr. Fiedziuszko was not a common law employee and was instead a statutory employee, notwithstanding that his employer failed to check the statutory employment box on his 2012 Form W-2. Mr. Fiedziuszko worked primarily from his home office rather the employer's offices and produced reports and patents according to his assignments from the employer.
>
> The court noted that, although it is not the exclusive factor, the degree of control exercised by a principal over an individual is the crucial test in determining the nature of a working relationship. The degree of control necessary to find an individual to be a common law employee is lower when applied to "professional" services. (*Fiedziuszko v. Comm.*, TC Memo 2018-75)

Statutory nonemployees are workers who are paid relative to their sales output, not based on hours worked, and who perform services under a written contract [IRC Sec. 3508]. To qualify, a worker must be a qualified real estate agent or a direct seller.

COMMON LAW EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

Proper classification of a worker has significant impact on overall cost of a worker. Workers classified as independent contractors:

- Do not need to be covered by workers' compensation insurance.
- Do not have employment-related taxes withheld from earnings or paid by the payer.
- Have no right to participate in employee fringe benefit programs, including health insurance (a key factor often causing dissension).
- Are not entitled to unemployment insurance benefits.
- Are not covered by various federal (and possibly state) employment regulations such as OSHA, minimum wage and hour laws, anti-discrimination laws, and the National Labor Relations Act.

The IRS and most states are very aggressive in auditing worker classification and the federal penalties for misclassifying workers may be quite severe:

- IRC Sec. 6651 – Failure to File: 5% per month up to 25%.
- IRC Sec. 6656 – Failure to Deposit Timely: 10% for 15 days or less and rising to 15%.
- IRC Sec. 6662 – Underpayment: 20% of underpayment if substantial understatement of tax of for negligence.
- IRC Sec. 6663 – Civil Fraud: 75% of underpayment attributable to fraud.
- IRC Sec. 6672 – Willful failure to collect and pay: 100% of tax not collected and paid.
- IRC Sec. 6674 – Willful furnishing of a false or fraudulent statement to an employee: $50 per form.
- IRC Sec. 6721 – Failure to file correct information returns: $50 per return up to $250,000 for a year.

- IRC Sec. 6722 – Failure to furnish correct payee statements: $50 per failure to provide Form(s) W-2s and 1099s.
- IRC Sec. 6723 – Failure to comply with other information reporting: $50 per failure up to $100,000 for a year.

The IRS may also assess criminal penalties:

- IRC Sec. 7202 – Willful failure to collect or pay tax: Maximum of $10,000 and prison for up to five years. In addition, see IRC Sec. 6674, above.
- IRC Sec. 7204 – Willful failure to provide statements to employees: Maximum of $100,000 and up to one year in prison.

State agencies are now sharing their findings with the IRS and vice versa. Don’t forget the state penalties.

The importance of the distinction between independent contractor and employee has become more important subsequent to passage of the TCJA and the creation of the qualified business income deduction (see Chapter 40 for more information).

DOL AND IRS TESTS FOR INDEPENDENT CONTRACTORS

The battle over non-employee status has raged for many years. With the advent of the new administration a succession of statements has been delivered indicating a more active compliance position regarding non-employee status in general.

Common Law 20-Factor Test

- Older test developed by the IRS to determine if an independent contractor classification is valid.
- This test isn't conclusive as to corporate officers and doesn't apply to statutory independent contractors.
- The test as applied in the *Dynamex* case has been adopted to some extent in most states, including California,
- The 20 factors are designed only as a guide and may be found listed in Rev. Rul. 87-41.

Newer Three-Factor Test

1. Behavioral Control. Facts that show whether a business has a right to control how a worker performs required tasks. The degree of instruction is important as well as the types of instructions given:
    a. When and where the work is performed.
    b. Whose tools or equipment are used.
    c. What workers to hire or to assist with the work.
    d. Training provided.

e. The key is whether a business controls or has the right to control the details of a worker's actions.

2. Financial Control. Facts that show whether a business has the right to control the business aspects of a worker's activities, including:

a. The extent to which the worker has unreimbursed business expenses.

b. The extent of the worker's investment in the facilities or tools used in performing services.

c. The extent to which the worker makes services available to other customers (i.e., marketing, business location).

d. The method by which the worker is paid (for example, is there a guaranteed wage versus a set fee at the project start).

e. The extent to which the worker can realize a profit or loss (e.g., who bears financial risk).

3. Relationship of the Parties. The substance of the relationship between the parties governs a worker's status. Factors that reflect the type of relationship include:

a. Are there written contracts describing the relationship (not determinative in and of itself)?

b. Is the worker provided with employee-type fringe benefits, such as insurance, pensions, sick or vacation pay, etc.?

c. The permanency of the relationship. An expectation of an indefinite ongoing relationship is generally considered to be evidence of an employer/employee relationship.

d. The extent to which services performed by a worker are an integral part of the regular business of the "employer."

On January 6, 2021, the Department of Labor, announced a final rule regarding the standard for employee versus independent contractor under the Fair Labor Standards Act (FLSA). The effective date of the final rule was March 8, 2021, that was intended to support the gig economy, "protecting" the status of gig workers. On March 12, 2021, the rule was withdrawn to allow the current administration to review the protections afforded by the DOL of gig workers in general. The general focus of the current administration is to protect employees; this has come with a promise that the DOL will focus on incorrectly classified non-employees.

Federal Statutory Provisions

An IRS worker classification audit often comes from a Department of Labor (DOL) investigation that is more likely to determine employee status than the other tests.

The DOL uses an economic realities test under the Fair Labor Standards Act (FLSA) using six factors:

1. The degree that the functions of a worker essential to the business operations,

2. The ongoing nature or permanency of the employer/worker relationship,

3. The extent a worker has invested in his own materials and supplies,

4. The control the employer has over a worker,

5. The degree that an employer has an effect on a worker's ability to generate a profit or loss, and

6. The level of a worker's skill, judgment, and initiative that is required to perform their necessary functions.

The IRS recognizes the degree of importance for each factor varies depending upon the occupation and the context in which services are performed. In certain occupations, some factors may not exist at all. Ultimately, the facts and circumstances of each situation play a role in a final determination.

COURT CASE: The Tax Court ruled an accountant was an employee, not an independent contractor. The accountant performed field audits for a firm. Here, the taxpayer signed a statement acknowledging he was an employee of the firm. The accountant reported his income on Schedule C and deducted auto expenses, office expenses, travel, etc. The court sided with the IRS. (*Daniel Feaster v. Comm.*, TC Memo 2010-157)

COURT CASE: A taxpayer was the owner of a law office, for which he engaged his wife, the owner of a "business services" sole proprietorship, to provide office services. With good records, the taxpayer demonstrated that his wife met all the tests of an independent contractor. (*Darryl Jones v. Comm.*, TC Memo 2014-125)

QUERY: Can a worker receive both Form W-2 and Form 1099-MISC for other services?

While the IRS has a bias against "dual service" workers, this treatment may be acceptable if a business can prove a worker renders significantly different services in each separate capacity. Some situations where the IRS has approved dual service workers include—

- The worker was an officer (statutory employee) and a director (independent contractor) for the same company (Rev. Rul. 57-505).
- The worker was an officer (statutory employee) and an insurance salesperson (independent contractor) for the same company (Rev. Rul. 58-505).
- The worker was both a licensed real estate agent (statutory nonemployee) and the company's bookkeeper (common law employee).

SECTION 530 RELIEF

Safe Harbor

Section 530 of the Revenue Act of 1978 prevents the IRS from reclassifying a worker as an employee if a business has a reasonable basis for and has consistently treated the worker as an independent contractor. It overrides statutory employee and common law control rules. Relief applies without regard to a worker's common law status.

To receive Section 530 relief (Rev. Proc. 85-18)—

- A business must have a reasonable basis for the classification.

- A business must consistently report all information and file all required Form 1099 forms [*Kurek v. Comm.*, TC Memo 2013-64].

- The current and any predecessor business must have consistently classified the worker as an independent contractor.

The safe harbor is only for employment tax purposes. It does not relieve an employer for other purposes (e.g., qualified retirement plans and fringe benefit plans). This means an employer may be able to treat a worker as an independent contractor for payroll purposes but as an employee for other purposes.

NOTE: The ACA's IRC Sec. 4980H penalty provisions (for applicable large employers) may create a problem for employers using Section 530 relief. Section 530 relief applies only for a company's federal employment tax responsibilities. For other purposes, including IRC Sec. 4980H, a worker is classified under the common law control rules. Therefore, if a full-time worker who a company is treating as an independent contractor under Section 530 is an employee under the common law rules, the employer may be subject to IRC Sec. 4980H's penalty if the worker (i.e., common law employee) is not offered affordable health insurance coverage that provides minimum value.

As part of the audit process, IRS agents must explore the applicability of Section 530, even if a business does not raise the issue. A plain language summary of Section 530 must be provided to a taxpayer at the beginning of an examination on worker classification.

Section 530 terminates a firm's, not a worker's, employment tax liability under IRC Subtitle C (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), federal income tax withholding, and Railroad Retirement Tax Act taxes), and any interest or penalties attributable to a liability for employment taxes [Rev. Proc. 85–18].

Reasonable Basis Requirement

PLANNING TIP: Reasonable basis is liberally construed in favor of the employer. The IRS restates this intent in almost all published guidance. A business must prove a prima facie case or produce a reasonable amount of evidence, rather than a preponderance of evidence as is normal.

There must be a reasonable basis for the classification. Evidence of reasonable basis includes:

- Reliance on a court case or IRS ruling. It must have been in existence at the time the business began treating workers as independent contractors.

- In a prior audit the IRS raised the issue of independent contractor versus employee and the workers were not reclassified.

- Is there a practice by a significant segment of the taxpayer's industry in the taxpayer's business community? To substantiate industry practice, the taxpayer will usually need to conduct a survey [*Nelly Home Care, Inc.*, 117 AFTR 2d 2016-1500 (DC PA)].

Whether a practice is longstanding depends on facts and circumstances. A practice that has existed for 10 years or more should always be treated as longstanding, but shorter periods have been allowed. Legislative history clarifies the 10-year rule is a safe harbor when—

- A significant segment of an industry generally consists of businesses located in the same area, provide the same product or service, and compete for the same customers.
- Under Section 530, 25% of a taxpayer's industry (not including the taxpayer) is deemed to be a significant segment of the industry. The legislative history notes a lower percentage may be a significant segment, depending on facts and circumstances.
- The business must have knowledge of the long-standing practice.
- The practice must have existed at the time independent contractor status began.
- Reliance on industry practice should be documented in records such as corporate minutes or unanimous consents in lieu of director's meetings.
- The IRS training guide suggests auditors interview workers to determine what reasons were given to them by the business when establishing their status as independent contractors. Therefore, it is advisable to inform workers at hiring of the reasons for independent contractor status and document it in writing.
- The best time to do a survey is before workers are hired. However, the IRS Training Manual tells the auditor not to reject a survey done during audit.
- Reliance on the advice of an attorney or accountant who knew the facts about the business may constitute reasonable basis.

Reporting Consistency and Classification Requirement

A business must consistently report all information and file all required Forms 1099. If Forms 1099 were filed for some but not all workers, relief is not available for any workers for whom Forms 1099 were not filed.

While Section 530 does not address timely filing of Forms 1099, the issue is addressed in Rev. Rul. 81-224, which states, "such relief will not be denied taxpayers who mistakenly but in good faith timely file Forms 1099 MISC."

Businesses that, in good faith, file the wrong type of Form 1099 do not lose Section 530 eligibility.

PLANNING TIP: The reporting consistency requirement applies on a worker-by-worker and a year-by-year basis. If a business files a proper Form 1099 for only a portion of its workers who are classified as independent contractors, relief is available relating only to those workers for whom a Form 1099 was filed.

If a business fails to file a proper Form 1099 for a worker in one year but files it in subsequent years, relief is only available for the years that the form was filed.

NOTE: Timely filing of Form 1099-NEC is also a prerequisite for a taxpayer to be considered for the Classification Settlement Program.

- The business must not have treated workers as employees during any prior tax year.
- A business or its predecessor must not have treated any other worker performing the same job or substantially the same job as an employee, effectively creating classes of workers. However, a business is entitled to treat two separate classes of workers differently.

EXAMPLE: Effects of inconsistent treatment of workers under Section 530

OMG, LLC has its tax return examined. OMG has 100 workers, all doing essentially the same job, at its manufacturing plant. On examination, it is discovered that three workers hired three years ago were treated as employees. Under Section 530, relief on all 100 workers would be denied because of an inconsistent treatment.

Workers Not Covered by Section 530

Section 530 relief is not available for technical workers who are employed by firms to provide services to third parties [Section 530, subsection (d)]. It does not apply to third party arrangements for engineers, designers, drafters, computer programmers, systems analysts, or other similarly skilled workers.

Congress' intent was to classify workers retained by businesses to provide technical services under the common law employee rules.

CLASSIFICATION SETTLEMENT PROGRAM (CSP)

IRS currently has two programs that employers can use to settle worker classification issues:

1. **The Classification Settlement Program (CSP)** offers employers that are under audit by the IRS the opportunity to pay only a portion of the employment taxes due for the year under audit in which workers were misclassified.
2. **The Voluntary Classification Settlement (VCSP)** program allows eligible employers to prospectively treat workers as employees; the VCSP is discussed below.

Employers under payroll audit can obtain relief from the most severe penalties by qualifying for, and electing to be covered by, the Classification Settlement Program (CSP). Under this program, the IRS offers eligible businesses discounts on back payroll tax liabilities. Employers must agree to change worker classification prospectively.

Taxpayers must begin treating workers as employees the first day of the quarter following the agreement date. For example, a CSP agreement is signed by a taxpayer and approved by the IRS on March 15th. The quarter ends March 31st. Therefore, a taxpayer should begin treating workers as employees on April 1st.

The settlement for taxpayers who have a potential reasonable basis argument requires a reduced deficiency assessment of 25% of the latest audit year. The 25% will be determined by computing the deficiency for the entire year, using IRC Sec. 3509, if applicable, and multiplying it by 0.25. The assessment will be made for the quarter ending December 31st.

The CSP is only available for worker classification issues to taxpayers who timely file Form 1099 informational returns.

EXAMPLE: Determining CSP eligibility

The IRS examines a painting company that engages the services of college students during the summer months to paint offices. The company timely filed Forms 1099. The owner's reasoning for treating the painters as independent contractors is discussions with other business owners at local building trade meetings that indicates other businesses also use independent contractor status in similar situations. The IRS determines the taxpayer's argument may have merit, even though research indicates that the local painting industry almost always treats painters as employees.

Result: The taxpayer is eligible for a CSP offer equal to an assessment of 25% of one year's deficiency.

The CSP program is a very process driven and procedural program. If the practitioner is not familiar with the rules of Section 530 and the terms of a CSP, it is important to engage an experienced practitioner.

VOLUNTARY CLASSIFICATION SETTLEMENT PROGRAM (VCSP)

The VCSP permits taxpayers who are not under an employment audit, even if under an IRS audit [Announcement 2012-45], to settle with the IRS regarding independent contractor/employee issues. It allows taxpayers to prospectively treat workers as employees.

To participate in VCSP, a taxpayer applies using Form 8952, which is filed 60 days prior to the date the taxpayer wants to begin treating the workers as employees.

The VCSP is a generous settlement option:

- The taxpayer will not be subject to a federal employment tax audit for worker classification of the workers being classified as employees for any prior year.

- The taxpayer pays 10% of the employment tax liability that would have been due on compensation paid the workers for the most recent tax year. The tax rates are based upon IRC Sec. 3509(a) rules. The actual calculation looks like this (from Form 8952):

Part IV	**Payment Calculation Using Section 3509(a) Rates** (see instructions)				
18	Enter total compensation paid in the most recently completed calendar year to all workers to be reclassified (see instructions)	18			
19	Multiply line 18 by 3.24% (.0324)			19	
20	Enter any compensation included on line 18 that exceeded the social security wage base for any worker or workers for the most recently completed calendar year (see instructions)	20			
21	Subtract line 20 from line 18	21			
22	Multiply line 21 by 7.44% (.0744) [7.04% (.0704) for compensation paid prior to 2013]			22	
23	Add lines 19 and 22			23	
24	Multiply line 23 by 10% (.10). This is the VCSP payment you will pay when you submit your signed closing agreement (see instructions)			24	

- There are no penalties or interest on this amount.

OBTAINING A WORKER CLASSIFICATION DETERMINATION

Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, should only be filed by an employer when requested by the IRS.

Filing an unsolicited Form SS-8 could cause an employer to be subjected to a worker-classification audit.

CAUTION: Form SS-8 may be filed by a worker concerned about his classification.

NOTE: The IRS addresses worker classification issues through the Small Business/Self-Employed Division's SS-8 Program and the Examination functions. In an April 2017 report, the Government Accountability Office determined that worker classification issues yielded the highest wage adjustments in employment tax examinations conducted by the Small Business/Self-Employed Division for Tax Years 2008 through 2010, with $44.3 billion in wage adjustments associated with worker classification issues.

COURT CASE: A worker filed a Form SS-8 and the IRS determined he was an employee. The employer was notified, protested to the IRS to no avail, subsequently filing an action to overturn the determination. The Tax Court held that a Form SS-8 and subsequent determination was not an "audit or examination," and accordingly, the Court had no jurisdiction (IRC Sec. 7436). In other words, unless an employer is audited or examined, there are no appeal rights to the Court. (*BG Painting, Inc. v. Comm.*, TC Memo 2016-62)

PROTECTING AGAINST WORKER RECLASSIFICATION

To help clients protect themselves from worker reclassification, practitioners should—

- Inform clients of potential dangers associated with treating employees as independent contractors and documenting the conversation.
- Review clients' current workers for potential misclassification and evaluate whether Section 530 applies.
- File all Forms 1099-MISC timely.
- Make sure employers have written agreements with their independent contractors.
- Encourage clients to require that independent contractors submit competitive bids.
- Discourage clients from giving independent contractors company benefits.
- Encourage the independent contractors to carry workers' compensation coverage.
- Discourage clients' from giving advances or loans to independent contractors.
- Encourage clients to keep independent contractor records as vendors separate from employee records and to not issue independent contractors business cards, IDs, voicemail, or email addresses.

- Encourage clients to keep vendor files containing bids, contracts, Form(s) W-9, workers' compensation insurance certificates and documentation of any work turned down by the worker.

FORM 8919, UNCOLLECTED SOCIAL SECURITY AND MEDICARE TAX

Form 8919 is used to calculate and pay an employee's share of payroll taxes not withheld by his employer. The form helps a *de facto* employee, treated as an independent contractor by his employer, avoid self-employment taxes. The form is also used by the IRS and the DOL to target employers who may be misclassifying workers.

On Form 8919, a worker must be able to cite one or more reasons for the filing (e.g., "I filed Form SS-8 with the IRS and haven't received a reply"). If a worker does not fit into one of the classifications, they can file a Form 8919, but must also file Form SS-8.

The worker reports the income as wages on Form 1040, Line 7, and pays an employee share of Social Security and Medicare taxes by filing the Form 8919.

PLANNING TIP: By filing Form 8919 and not declaring the income as self-employment income, a taxpayer will reduce their Social Security and Medicare taxes by about one-half.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 1779, *Independent Contractor or Employee Brochure*
- IRS Pub. 1976, *Do You Qualify for Relief under Section 530?*
- Internal Revenue Manual, *Examining Process, Part 4 (4.23.5): Technical Guidelines for Employment Tax Issues* (**www.irs.gov/irm/part4/irm_04-023-005r**)
- Internal Revenue Manual, *Examining Process: Classification Settlement Program (CSP)* (**www.irs.gov/irm/part4/irm_04-023-006**)
- IRS VCSP information (**www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program-vcsp-frequently-asked-questions**)
- IRS assistance: *Independent Contractor (Self-Employed) or Employee?* (**www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee**)

CHAPTER 28: WORKER NEXUS

Learning Objectives

Completion of this chapter will enable participants to—

- Recognize the need to assist a client with issues of nexus.
- Identify issues that create nexus for taxpayers for income tax.
- Consult with taxpayers on recordkeeping for multistate compliance.

WHAT'S NEW?

- The remote worker presents growing challenges to establishment of nexus for income tax purposes.
- Growing challenges of determination of economic nexus rules.

GROWING BURDEN OF NEXUS IDENTIFICATION ON INDIVIDUALS AND SMALL BUSINESSES

A better understanding of the nature of the business beyond the location of the property and/or the payroll is required now to determine nexus. States started applying the theories of economic nexus with the decision rendered by the *Tax Commissioner v. MBNA America Bank*, N.A., 640 S.E. 2d 226 (W. Va. 2006), with a Supreme Court decision by the West Virginia court that states were not limited to physical presence for determination of nexus.

However, the Federal Interstate Act of 1959 continued to be a lifeline for business. When determining nexus, a look at the interpretation of the act by the Multistate Tax Commission (MTC) was the primary reference used by states and taxpayers alike. Updates were made by MTC in 1993, 1994, and 2001. A public hearing was held in August 2020 with a publication of the hearing officer's findings on 10/30/2020. The result of the hearing officer's report was the inclusion of numerous unprotected activities that would subject the enterprise to nexus in the jurisdiction. One of the most frequent questions now is how this applies to worker nexus for their individual income tax purposes. Insert the concept of the individual worker to determine does a particular state have the ability to tax the worker:

- The worker performs post-sale assistance to in-state customers via either electronic chat or email that customers initiate by clicking on an icon on the business's website. For example, the business regularly advises customers on how to use products after they have been delivered.
- The worker on behalf of the business solicits and receives online applications for its branded credit card via the business's website. The issued cards will generate interest income and fees for the business.
- The worker performs the service for the business to remotely fix, or upgrade products previously purchased by its in-state customers by transmitting code or other electronic instructions to those products via the internet.

As stated by The Tax Adviser (see **www.thetaxadviser.com/issues/2021/mar/erosion-nexus-protection-burden-small-businesses.html**), many small businesses continue to overlook this important report. The failure to identify the income tax nexus of the taxpayer leads to income taxes paid to the home jurisdiction with the "remote" jurisdiction many years later extending its hand and demanding payment for its share. When this happens income taxes which normally are credited with a "foreign tax" reduction fail to obtain this reduction as statutes expire.

EXAMPLE: Effects of various nexus issues

Scenario 1: State A and State B have a reciprocal agreement for workers, residents of A who work in State B will only be taxed in State A. While border states are very familiar with this agreement, interior businesses are not as well versed with this arrangement. A worker who lives in State A while in the employ of State B business may find that they have been subjected to State B withholding. While the worker's W-2 indicates the wages are State B wages, due to the reciprocal agreement they are in fact State A wages, corrective action will be taken when filing the state tax returns of the worker.

Scenario 2: The worker's residence is in State A but works in State B. However, the payroll department for the worker's company did not understand the payroll rules and provided a W-2 to the worker indicating the wages were earned in their state of residency and not where the worker performed the services.

Scenario 3: SP (sole proprietorship) in State A has a delivery truck which delivers their goods to customers in State B. While State A and B have a reciprocal agreement for employees, there is no such agreement for self-employed, based on the sales agreement with SP's customers, State B is considered the point of sale.

In each of the previous examples, the tax preparer is going to be required to help the client determine nexus to properly prepare the state tax returns of the client. Each of the examples are straightforward scenarios of nexus issues. In the real world, the problem is much more complex and difficult. This chapter attempts to address some of those issues.

Additional issues highlighted by history included one situation in which "small amounts" of inventory held in an Amazon warehouse in California by an Illinois business using the Fulfillment by Amazon (FBA) service, which resulted in California contacting the Illinois business to seek its California income tax return because "property" was located in the state of California. Many small businesses discontinued their concern long ago believing that Amazon collecting sales tax from the appropriate jurisdiction(s) had already solved their problems.

While actions by the MTC are not binding law, their action on November 20, 2020 indicates they will be surveying states to determine their "posture" on these issues. The expected outcome will be thoughts not currently being acted upon by state departments of revenue (DORs) will become actionable items in the growing competition for tax revenue by the states. There has been a considerable amount of focus on the *Wayfair* decision, but the income tax problems are considerably more complex.

ENFORCEMENT TRENDS

As revenue-starved states search for sources of income, increasingly aggressive postures are being taken by the states' DORs and in some cases counties or cities. These include, but are not limited, to "worker activity." The intent of these communications seems to be more of a scare tactic currently than a stronger compliance posture, as DORs are lacking personnel to be as effective with in-person taxpayer visits. However, these inquiries should not be ignored, as failure to respond can lead to additional contact later or future enforcement action based on incorrect, incomplete, or fraudulent responses.

States have other resources they can use to identify those employees who may have nexus. These include property tax records and in-state purchases using in-state mailing address, Form 1099-MISC or 1099-NEC, or examinations of other enterprises in the state indicating delivery in the state by the enterprise.

REDUCING RISK AND RESPONDING TO AN AUDIT

Taxpayers should be aware of the requirements in the states they spend time in and monitor both their physical and economic presence on a regular basis. Taxpayers should respond to any challenges of a jurisdiction challenging their nexus status in the state and/or local government and become familiar with any tools that might be offered by the state to assist in compliance with nexus rules and use them. Dealing with a notice of allegations of nexus by a jurisdiction is considerably more difficult to address rather than proactively registering and starting collection/payment of the applicable taxes.

HELPING CLIENTS GET A HANDLE ON ECONOMIC NEXUS

As a result of remote work, many workers are encountering nexus issues. Due to the coronavirus pandemic, a conversation typically goes a little like this:

1. The worker was sent home because of COVID.

2. The taxpayer determined that they could keep the wheels of commerce turning by having employees work remotely from their homes.

3. The employee lives in a neighboring state, or to protect their family, they relocated to a more remote site, such as a vacation home in the woods in a state which is different from the employer's location. In some instances, employees have moved to a home in a favorite retirement state, such as Florida, permanently, as the determination was made that remote working could be structured to work effectively for the balance of the employee's career.

4. Nexus questions abound now, including employment in another state and services/products now being delivered from a location that is not the "home" of the employer.

WORKER NEXUS

Workers have moved from their traditional workplaces to their homes. Given the choice, 40% of employees have indicated they would choose to remain at home. Most states have indicated that during the time of the pandemic crisis they will "waive" issues associated with state nexus, continuing to tax the worker in the same manner as prior to the pandemic. It should be noted that all but nine states have income/payroll tax rules which require withholding. The question preparers of individual tax returns face is whose responsibility is it to determine where the worker pays income tax.

An employer might be required to withhold income tax from wages for an employee's state of residence—even if the employee does not perform services there—if the employer has a business presence or operations in that state. The presence of a business location, such as an office, store, or factory in the state will create nexus there, as will the mere entry of a worker to make a sale or perform a service call. Normally, practitioners depend on the employer to determine which state the worker earned the wages.

During the COVID-19 public health crisis, many state tax agencies have issued guidance waiving nexus during the emergency period if it would have been established by the presence of resident employees working temporarily from home solely due to the pandemic. Most state guidance goes on to state that nexus might be established in the future if the remote work continues beyond the emergency period. The current question has thus become, when does the "emergency period" end?

It is important to note that the nexus home of a worker is not always the same as the IRS's definition of a tax home. A review of a recent tax court case, *Soboyede* (TC Summary Opinion 2021-3, 01/26/2021), clearly indicates that the IRS does not necessarily consider a taxpayer's primary residence to be their tax home for federal purposes. The same can be said for the state view of residency or working from whatever location. Of note is in the previously mentioned case in which the court found the "tax home" of the worker to be the hotel where he was staying that was proximate to his business activities. Will this mean that where that hotel room is located will be considered to be the worker's current tax home? The answer in most cases will be yes. In most states, this would necessitate the filing of a state tax return for the earnings for which the worker would receive a "credit" in the worker's home state/state of residence.

As the mobility of the workforce increases, the tax complications grow at the same pace. It is difficult to determine how to deal with a W-2 that indicates that worker income was from state X while the worker indicates they also worked in state Y:

- How do we prepare the state return?
- Who is responsible for the state determination?
- Does the worker have tax compliance issues?
- Can the state where the worker worked but the employer failed to determine correctly assess the worker at a future date?

The test to determine when a worker is considered physically present in a particular jurisdiction varies (see **www.mobileworkforcecoalition.org/problem**). Some states allow workers to be in the state for more than 30 days before they have earned physical nexus. Others consider a worker present and subject to state payroll rules on day one. Some states suspended their "resident" worker rules during the pandemic, allowing those who were working from a non-work location to continue to be treated in the same way they were prior to the pandemic.

The actual withholding requirements for a jurisdiction seldom are the same from state to state and from local jurisdiction to local jurisdiction. Three rules must be examined in most jurisdictions:

1. *Residence Definition* – Is the worker domiciled in the state or is the worker spending in excess of a specific number of days in the locale (defined by state statute)?
2. *Reciprocity* – Some states have agreements with other states that do not apply payroll taxes to residents of another state that have filed statements of residency with the nonresident state.
3. *Resident/Nonresident Taxation Policies* – If an employee is a resident of one state but performs services in another, and there is no reciprocal agreement, you must consider the laws of both states. There are many different rules depending on the jurisdiction.
4. *Telecommuters* – Generally, an individual will be subject to tax in the state of their residence, but several states have convenience of the employer tests. This means that an employee who works from their home for their own convenience is considered to be actually working at the employer's location.

States have identified workers who have attended trade shows and took orders during that event. It was determined that the employee was a nonresident worker for that period requiring state withholding, unemployment and any other payroll taxes required by the jurisdiction. The question for many workers is "When is a nonresident worker responsible for a misclassification made by the employer?" The answer is *it depends*. Some are subject to them on day one while others must reach a specific threshold. The current patchwork of state laws has made it very easy to make an error regarding employment nexus.

EXAMPLE: Worker nexus—convenience of the employer versus the worker

Sally, a Connecticut resident, works two days at home and three days in New York each week. Because it is her "residence state," Connecticut will tax her on the full five days of income. New York will tax the income earned over the three days in New York, and it will tax the income earned over the two days in Connecticut unless Sally can prove that her work was performed at home for her employer's convenience (an easy process during the closure orders) and not for her own convenience (very hard to prove under normal circumstances). It gets worse because Connecticut will not give Sally a credit for taxes paid to New York because Connecticut does not recognize New York's authority to tax Sally.

Variation 1: New York has opened its doors post shelter-in-place restrictions, but her employer asks Sally to continue working remotely to protect her and the staff from a company-wide infection. Is this situation for the convenience of her employer? Are there other considerations?

Variation 2: Sally's employer has put in a place the ability of an employee to request to continue to work from home (most days) for demonstratable personal reasons. Sally chooses to take advantage of these rules by continuing to work from home. Despite the fact Sally is working from home, based on workplace rules, she is working from home for her convenience not the employers. Sally will be subject to the rules as applied in Variation 1

The battle over payroll taxes has already started as the country emerges from the pandemic world of the remote employee. In March 2020, Massachusetts established a rule stating that if a worker at one time commuted to Massachusetts, that worker who was working in a "remote" capacity would now continue to be subject to state income taxes. New Hampshire replied by pursing a federal determination that the rule is a restraint of interstate commerce. New York, as demonstrated in the previous example, has applied the convenience of the employer rule for many years. Other states with convenience of the employer rules, such as Connecticut, Delaware, Nebraska, and Pennsylvania, predate the country's battle with COVID-19. Currently, the Supreme Court of the United States has yet to weigh in on this issue.

LEGISLATIVE UPDATE: An act that has been passed by the U.S. House in the last three sessions, the *Mobile Workforce State Income Tax Simplification Act* (**www.congress.gov/bill/117th-congress/house-bill/429/text**), could make the process less difficult, as the sole requirement is that a worker be present in the state for 30 days before being subject to a nonresident state's taxation. As this manual went to press, the Senate had not yet passed the act. However, two of the advocacy groups for the bill, the Mobile Workforce Coalition and AICPA, believe the Act may have more support in the 2021–2022 session. In February 2021, the Senate voted on the inclusion of the Mobile Workforce legislation, which received bipartisan support for inclusion in the 2021 budget resolution. This support was far more extensive than had been seen from the Senate in previous proposals from the Mobile Workforce initiative.

CHAPTER 29: SELF-EMPLOYMENT TAX

Learning Objectives

Completion of this chapter will enable participants to—

- Determine income subject to self-employment tax.
- Apply the self-employment taxation exclusion applicable to rentals from real estate.

FRAMEWORK—GENERAL RULES

For purposes of the self-employment (SE) tax, self-employment income means the net earnings from self-employment derived by an individual subject to the SE tax during the tax year. Only earned income is subject to SE tax. IRC Sec. 1402(a) states—

> The term 'net earnings from self-employment' means 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; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss.

DEVELOPMENT: According to CCA 202009024, for SE tax purposes, IRC Sec. 704(d)'s basis loss limitation rules and IRC Sec. 465's at-risk loss limitation rules apply in determining a general partner's net earnings from self-employment under IRC Sec. 1402, to the same extent those loss limitation rules apply for income tax purposes, unless a specific Section 1402 exclusion applies to the facts of particular case.

For example, assume an individual has a $50,000 passive activity loss for a taxable year, all of which is disallowed under Reg. §1.469-1T(a)(1). All of the disallowed loss is allocated under Reg. §1.469-1T(f) to activities that are trades or businesses [within the meaning of IRC Sec. 1402(c)].

The loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to federal personal income tax. In addition, the loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under IRC Sec. 1401.

If net earnings from self-employment for a tax year are less than specified dollar amounts, self-employment income for that year is zero. Generally, self-employment income does not include net earnings from self-employment of an individual when the amount of net earnings from self-employment for the tax year is less than $400 ($100 for certain church employees [IRC Sec. 1402(j)(2)(B)]).

PLANNING TIP: Since a 7.65% deduction is allowed from net profits from a trade or business (i.e., net earnings from self-employment before the 7.65% deduction), the actual net profits from a trade or business that an individual is allowed before becoming subject to the self-employment tax is $432 (92.35% × $433 = $400).

Certain deductions for income tax purposes are not allowed when calculating net earnings from self-employment, even though they relate to the trade or business activity generating the SE tax liability. Examples of such deductions include the IRC Sec. 199A qualified business income deduction, net operating loss carryovers [IRC Sec. 1402(a)(4)], the self-employed individual's health insurance deduction [IRC Sec. 162(l)(4)], and retirement contribution deductions.

The SE tax consists of the *old-age survivors, and disability insurance* (OASDI), or "social security tax," and the *hospital insurance* (HI), or "Medicare tax." Social security tax equals 12.4% (6.2% employee plus 6.2% employer equals 12.4%). The OASDI 2021 maximum wage base is $142,800. Medicare tax equals 2.9% (1.45% employee plus 1.45% employer equals 2.9%). The HI wage base is unlimited.

For certain high-income taxpayers, there is an additional 0.9% additional Medicare tax. Taxpayers with earned income over $250,000 (married filing joint), $125,000 (married filing separately), and $200,000 (single) are subject to the additional Medicare tax. The additional 0.9% tax is not included in the adjustment to gross income for the employer's portion of SE tax.

Special rules apply in determining self-employment income of certain individuals, including partners, farmers, fiduciaries, ministers and members of certain religious groups, and church employees.

To be engaged in a trade or business generally requires that the taxpayer be involved in the activity with continuity and regularity and have the intent of making a profit. Earned income received from an isolated or sporadic activity that differs from the taxpayer's regular trade or business is generally not subject to SE tax because it does not rise to the level of a trade or business.

The trade or business must be carried on by the individual, either personally or through agents or employees, in order for the income to be included in his net earnings from self-employment.

Income from a trade or business carried on by an estate or trust is not considered SE income for the beneficiaries. [Reg. §1.1402(a)-2(b); TAMs 200305001 and 200305002]

COURT CASE: In *Mathews*, the taxpayer was a Minister who also worked for a trucking company. He properly reported his wages from the trucking company but also showed his ministry income of $11,200 and related expenses of $31,230 on a Schedule C. The IRS disallowed all the expenses and charged Mr. Mathews with both income tax and SE Tax on the $11,200. However, the Tax Court concluded that while Mr. Mathews's income is subject to income tax, his work as a Minister should not have been reported on Schedule C and was not subject to SE tax. (*Clarence J. Mathews v. Comm.*, T.C. Memo 2021-28)

PLANNING TIP: S corporation interests do not generate SE income for shareholders.

RECENT GUIDANCE: In Program Manager Technical Advice (PMTA) 2018-021, the IRS clarified that Market Facilitation Program (MFP) payments authorized by the U.S. Department of Agriculture (USDA) are includible in gross income under IRC Sec. 61 and are generally included in net earnings from self-employment under IRC Sec. 1402.

The MFP gives direct payments to producers of specified crops adversely affected by the tariffs and is intended to make up for the depressed prices of certain commodities caused by the tariffs.

Courts have consistently held that payments intended to compensate a taxpayer for lost profits must be included in gross income. And, courts have held that government subsidy and conservation payments are properly includible in gross income. The IRS also issued a number of revenue rulings (e.g., Rev. Rul. 73-408) that generally adhere to this principle.

Accordingly, the PMTA finds that the MFP payments at issue are government subsidies paid for the purpose of compensating farmers of specified crops for lost profits, and that there is no current legislation under which they are excluded from gross income. The PMTA finds that the payments are includible in gross income under IRC Sec. 61(a) and also generally includible in net earnings from self-employment and subject to SE tax.

KEY EXCEPTIONS

Rental Income

Rentals from real estate and from personal property leased with the real estate are excluded from SE taxation, unless such rentals are received in the course of a trade or business as a real estate dealer [IRC Sec. 1402(a)(1)].

In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real estate dealer [Reg. §1.1402(a)-4]. On the other hand, an individual who merely holds real estate for investment or speculation and receives rental income is not considered a real estate dealer (*Blythe v. Comm.*, T.C. Memo 1999-11; CCA 200816030).

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

Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple-housing units are generally rentals from real estate. Again, the rental payments are excluded from determining net earnings from self-employment (except in the case of real estate dealers).

Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant are included in determining net earnings from self-employment. Services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually provided in connection with the rental of rooms or other space for occupancy only (e.g., concierge and maid service).

NOTE: Hotels, boarding houses, apartment houses furnishing hotel services, tourist camps, tourist homes, payments for the use or occupancy of space in parking lots, warehouses, storage garages are not considered rentals from real estate [Reg. §1.1402(a)-4(c)(2)].

However, the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, and the collection of trash are not considered as services rendered to the occupant.

NOTE: In Rev. Rul. 55-559, the taxpayer owned an office building from which he derived income from the rental of space. The building was not held for sale in the course of a trade or business as a real estate dealer but was held solely for investment purposes. He provided heat, water and electricity to the occupants of the building, as well as a trash and garbage collection service, and he employed a full-time janitor. The IRS concluded the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, were not considered as services rendered to the occupant. Accordingly, the taxpayer's income was excluded in computing net earnings from self-employment.

Dividends and Interest Income

Dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof) are excluded from SE taxation, unless such dividends and interest are received in the course of a trade or business as a dealer in stocks or securities [IRC Sec. 1402(a)(2)].

Certain gains and losses are excluded from SE taxation [IRC Sec. 1402(a)(3)], including:

1. Gain or loss from the sale or exchange of a capital asset;
2. Gain or loss from the cutting of timber, or the disposal of timber, coal, or iron ore, if IRC Sec. 631 applies to such gain or loss; or
3. Gain or loss from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor property held primarily for sale to customers in the ordinary course of the trade or business.

COURT CASE: In *Dunlap*, the question before the court was whether payments Ms. Dunlap received from Mary Kay during 2014 and 2015 were subject to self-employment tax.

As a national sales director, Ms. Dunlap could participate in the Family Security Program (FSP). The benefit of the FSP was that it provided a national sales director with financial security should she retire or be unable to work. Under the FSP, at 65 years of age, Ms. Dunlap's relationship with Mary Kay and any payments for sales or commissions from Mary Kay would end. At 65 she was eligible to receive FSP payments, but she could no longer be involved in a tiered business relationship under Mary Kay. Her business relationship with Mary Kay terminated, but under the FSP, she or her estate would receive 15 years of payments based on her high-average tiered sales activity.

Mary Kay subsequently informed Ms. Dunlap that the FSP was intended to be a nonqualified deferred compensation arrangement that met the requirements of IRC Sec. 409A. IRC Sec. 409A provides for the inclusion in gross income of deferred compensation from a nonqualified deferred compensation plan.

The payments under the FSP are calculated on the basis of sales and commissions and are being paid at a rate of 60% of a high-average tiered sales activity. Given that, and despite several taxpayer arguments to the contrary (including an unsuccessful argument that the proceeds were actually received in exchange for Ms. Dunlap's business and/or goodwill), the court found that the FSP payments received in 2014 and 2015 were subject to self-employment tax. (*Dunlap v. Comm.*, TC Summary Opinion 2020-10)

Community Property State Rules

Special rules apply if the spouses live in a community property state. IRC Sec. 1402(a)(5)(A) states that if any income derived from a trade or business is community income (under the community property laws applicable to that state), all of the gross income and deductions attributable to such trade or business shall be treated as gross income and deductions of the spouse carrying on the trade or business.

If both spouses operate the business, the self-employment income is allocated based on each spouse's participation in the business. This is also extended to partnership income [IRC Sec. 1402(a)(5)(B)]. Each partner reports the distributive share of income in computing net earnings from self-employment; no part of such share is attributed to the other spouse.

The income and deductions must be allocated 100% to the earning spouse for SE purposes unless the other spouse exercises substantially all of the management and control, in which case that spouse is allocated 100% for SE purposes [Reg. §1.1402(a)-8(a)].

The partner spouse reports his distributive share of partnership income for SE taxation purposes. The non-partner spouse reports none [IRC Sec. §1.1402(a)(5)(B)].

PLANNING TIP: SE tax savings strategies may include unwinding existing partnerships (including LLCs) and converting them to sole proprietorships to save SE tax, or converting a sole proprietorship (including a SMLLC) to a partnership to save SE tax.

EXAMPLE: SE tax treatment of spouse-owned business

Desi and Lucy are married. Desi earns $90,000 as a sole proprietor singing Latin music. Lucy works in the business with Desi, making jokes and billing clients. Lucy also works for an investment advisor making $170,000 as an employee. By converting to a spouse-owned multi-member LLC, they will gain liability protection and save $5,153 on SE tax ($45,000 × 0.9235 × 12.4%).

Religious Personnel

Generally, although a parsonage allowance is excluded from income for income tax purposes, allowances of active (as opposed to retired) ministers must be included in calculating their self-employment income for SE tax purposes [IRC Sec. 1402(a)(8)].

Duly ordained, commissioned, or licensed ministers, members of a religious order who haven't taken a vow of poverty, and Christian Science practitioners may elect to be exempt from SE tax. The exemption is also available to ordained priests and rabbis.

Members of religious orders who have taken a vow of poverty are compulsorily excluded from coverage and needn't file any application to secure an exemption.

The application for exemption must be filed in triplicate on Form 4361, Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners, with the IRS office designated in the form's instructions.

Partner Retirement Income

Excluded from SE taxation are certain retirement amounts received by a partner pursuant to a written plan of the partnership. The excluded payments must be made on a periodic basis to partners (or to a class or classes of partners), continue at least until such partner's death and—

1. The partner must render no services with respect to any trade or business carried on by such partnership (or its successors) during the taxable year of such partnership (or its successors), ending within or with his taxable year, in which such amounts were received;

2. No obligation must exist (as of the close of the partnership's taxable year) from the other partners to such partner except with respect to retirement payments under such plan; and

3. The partner's share, if any, of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year.

The distributive share of any item of income or loss of a limited partner are excluded from SE taxation [IRC Sec. 1402(a)(13)]. Guaranteed payments paid to the limited partner for services rendered to (or on behalf of) the partnership is SE income.

Qualified Joint Ventures

Earnings from a qualified joint venture (QJV) will be allocated to each spouse based on their respective interest for SE tax purposes [IRC Sec. 1402(a)(17)]. (See Chapter 23 for a comprehensive discussion of QJVs.)

DELAY OF SELF-EMPLOYMENT TAX PAYMENTS

The Paycheck Protection Plan Flexibility Act (enacted on June 5, 2020) amended CARES Act §2302, striking the rule that would have prevented an employer (or self-employed individual) from deferring the deposit and payment of the employer's share of Social Security tax after the employer (or self-employed individual) received a decision that its PPP loan was forgiven by the lender. Therefore, an employer (or self-employed individual) that receives a PPP loan is entitled to defer the payment and deposit of the employer's share of Social Security tax, even if the loan is forgiven.

CARES Act §2302 allowed taxpayers to defer paying the employer portion of certain payroll taxes through the end of 2020. The relief also applies to taxpayers subject to the self-employment tax. In other words, the payment for applicable employment taxes (or self-employment taxes) for the payroll tax deferral period won't be due before the applicable date.

The term *applicable employment taxes* means the employer's share of taxes imposed under IRC Sec. 3111(a) (i.e., 6.2% social security taxes). The term *payroll tax deferral period* means the period beginning on the date of enactment of the CARES Act (March 27, 2020) and ending before January 1, 2021.

An employer (or self-employed individual) will be treated as having timely made all deposits of applicable employment taxes required to be made during the payroll tax deferral period if all such deposits are made not later than the applicable date:

- 50% of stated self-employment tax: Paid on or by December 31, 2021
- 50% of stated self-employment tax: Paid on or by December 31, 2022

PLANNING TIP: For purposes of applying IRC Sec. 6654 (requiring individuals to make estimated tax payments) to any tax year which includes any part of the payroll tax deferral period, 50% of the self-employment taxes imposed under IRC Sec. 1401(a) for the payroll tax deferral period will not be treated as taxes to which IRC Sec. 6654 applies.

NOTE: According to IRS FAQs, self-employed individuals may use any reasonable method to allocate 50% of the social security portion of self-employment tax attributable to net earnings from self-employment earned during March 27, 2020, through December 31, 2020.

For example, an individual may allocate 22.5% of annual earnings from self-employment to the period from January 1, 2020, through March 26, 2020, and 77.5% of annual earnings to the period from March 27, 2020, through December 31, 2020.

Similarly, an individual may use any reasonable method in applying the social security wage base or taking into account partnership income in determining the portion of 50% of the Social Security portion of self-employment tax attributable to net earnings from self-employment for the period from March 27, 2020, through December 31, 2020.

EXAMPLE: Determining SE tax deferral amounts

Jason has $100,000 of self-employment income for calendar 2020. He earned no other income during the tax year.

Jason allocates 22.5% ($22,500) to earnings from self-employment for the period January 1, 2020–March 26, 2020. The remaining 77.5% ($77,500) of self-employment earnings was allocated to the period March 27, 2020–December 31, 2020.

The applicable employment taxes eligible for deferral were $4,438 [($77,500 × 92.35%) × 6.2%].

Jason will be treated as having timely made all deposits of applicable employment taxes required to be made during the payroll tax deferral period if he pays $2,219 on or by December 31, 2021, and the remaining $2,219 on or by December 31, 2022.

LIMITED LIABILITY COMPANY (LLC) MEMBERS TAXED AS PARTNERS

It is a long-standing rule that bona fide members of a partnership are not employees, and partnership income is not considered wages subject to FICA, FUTA, and income tax withholding [Rev. Rul. 69-184; CCA 201436049]. Partners or members taxed as partners are self-employed individuals.

> **NOTE:** In Reg. §301.7701-2, the IRS clarified the federal employment tax treatment of partners in a partnership that owns a disregarded entity such as a single-member LLC. The final regulation stipulates that such partners cannot be treated as employees of the disregarded entity. Reg. §301.7701-2 is effective as of the later of August 1, 2016, or the first day of the latest starting plan year beginning after May 4, 2016 and on or before May 4, 2017, of an affected plan (e.g., Section 125 plan) sponsored by an entity that is disregarded as an entity separate from its owner.

The distributive share of any item of income or loss of a limited partner are excluded from SE taxation [IRC Sec. 1402(a)(13)]. With the growth in LLCs and LLPs over recent decades, there has been an expanding discussion over the accurate definition of a limited partner. In 1997, the IRS proposed regulations that defined limited partner for self-employment tax purposes and would apply to all entities classified as a partnership. Generally, an individual would be treated as a limited partner unless the person [Prop. Reg. §1.1402(a)-2(h)]:

1. Has personal liability for the debts of, or claims against, the partnership by reason of being a partner [Reg. §301.7701-3(b)(2)(ii)].
2. Has authority (under state law) to contract on behalf of the partnership; or
3. Participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

> **NOTE:** An individual who is a service partner may not be a limited partner [Prop. Reg. §1.1402(a)-2(h)(5)]. A service partnership is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.
>
> The proposed regulations also offer two limited exceptions: one for holders of more than one class of interest and one for holders of only one class of interest that fail to meet the definition of limited partner solely because they participate in the partnership's trade or business for more than 500 hours during the tax year.

Recent developments indicate that active members in an LLC must report some or all their income allocation as SE income.

> **COURT CASES:** In *Joseph*, to support his argument that his partnership net income was not subject to self-employment tax, the taxpayer ultimately argued his partnership ownership interests "[. . .] are in the nature of limited partnership interests." Unfortunately for the taxpayer, there was no such status identified under state law or in the specific interest of the taxpayer in the entity at issue. The court went on to cite *Renkemeyer* (see below), noting that only if the holder is merely a passive investor in the entity who does not actively participate in the entity's business operations, do they qualify as a limited partner. As the taxpayer did not establish that he was merely a passive investor in the partnership at issue, the taxpayer's income from the partnership was subject to self-employment tax. (*Joseph v. Comm.*, TC Memo 2020-65)

In *Castigliola*, the Tax Court held that, while neither the Code nor any regulatory authority define limited partner for purposes of the IRC Sec. 1402(a)(13) rule that excludes certain partnership income earned by limited partners from the self-employment tax base, under the ordinary meaning of the term limited partner, the taxpayers—attorneys who were members of a professional limited liability company (PLLC)—were not limited partners under IRC Sec. 1402(a)(13). (*Castigliola v. Comm.*, T.C. Memo 2017-62)

In *Riether*, a district court found that partners were subject to self-employment tax on their distributive shares from a limited liability company (LLC) treated as a partnership. The court rejected the partners' arguments that: (1) they were employees of the partnership, rather than self-employed, because the LLC issued them a Form W-2, Wage and Tax Statement, (in addition to a Schedule K-1); and (2) the income from the LLC was "unearned income not subject to the self-employment tax." The court concluded the partners should have treated all the LLC's income as self-employment income, rather than characterizing some as wages. [*Riether v. U.S.*, (DC NM 2012) 112 AFTR 2d 2013-6074]

In *Renkemeyer*, the Tax Court determined that limited partners in a partnership that provided legal services had self-employment income where the attorney-partners' distributive shares of the law firm's income were generated by legal services that the partners performed on the law firm's behalf. This was the case, even though the interests were designated as limited partnership interests and the partnership was properly established under State law. The court concluded that the partners weren't limited partners within the meaning of IRC Sec. 1402(a)(13), and so their distributive share of the partnership's fee income was subject to self-employment tax. *Renkemeyer, Campbell & Weaver, LLP*, (2011) 136 TC 137]

MORE LIMITED PARTNER ISSUES: In CCA 201640014, the IRS concluded that a franchisee who owned and operated a number of restaurants through a partnership was not a limited partner exempt from self-employment tax under IRC Sec. 1402(a)(13) on his distributive share of partnership income.

The CCA points out that the hallmark of a limited partner is someone whose interest is generally akin to a passive investor (i.e., someone who lacks management powers but enjoys immunity from liability for debts of the partnership). Franchisee didn't exhibit these characteristics. He had sole authority over the partnership and was its majority owner, operating manager, president, and chief executive officer with ultimate authority over every employee and each aspect of the business. As such, he was not a mere investor, but rather an active participant in the partnership's operations who performed extensive executive and operational management services for the partnership in his capacity as a partner (i.e., acting in the manner of a self-employed person). As a result, the income Franchisee earned through the partnership wasn't income of a mere passive investor that Congress sought to exclude from self-employment tax under IRC Sec. 1402(a)(13).

In CCA 201436049, the IRS concluded that partners of a partnership whose primary source of income was from fees for providing investment management services were not limited partners exempt from self-employment tax under IRC Sec. 1402(a)(13) on their distributive shares of partnership income. The IRS found that the taxpayers' earnings weren't in the nature of a return on a capital investment, but were a direct result of the services rendered to the LLC by the partners. The LLC couldn't change the character of its partners' distributive shares by paying amounts mislabeled as so-called wages. The LLC was not a corporation and the reasonable compensation rules applicable to corporations did not apply.

WHERE TO GO FOR MORE INFORMATION

- IRS FAQs on the deferral of employment tax deposits and payments through December 31, 2020 at **www.irs.gov/newsroom/deferral-of-employment-tax-deposits-and-payments-through-december-31-2020**
- IRS Pub. 15-A, *Employer's Supplemental Tax Guide*
- IRS Pub. 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*
- IRS Pub. 3402, *Taxation of Limited Liability Companies*

CHAPTER 30: CAPITALIZATION AND AMORTIZATION—AUTOMOBILES

Learning Objectives

Completion of this chapter will enable participants to—

- Determine the appropriate amount of depreciation for a business vehicle
- Determine the amount of the taxable fringe of an employer-provided vehicle

WHAT'S NEW

1. New 2021 automobile limits and lease inclusion amounts
2. New Sec. 179 expensing and acquisition limits.

WHEN DEPRECIATION BEGINS AND ENDS

Depreciation begins when an asset is first placed in service for use in a trade or business or for production of income. The term first placed in service refers to the time the property is first placed in service by the taxpayer. Property is first placed in service when first placed in a condition or state of readiness and is available for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity [Reg. §1.167(a)-11(e)(1)].

Depreciation ends when an asset is retired from service, whether via a sale or exchange, conversion to personal use, abandonment, transfer of the property to a supplies or scrap account, or destruction.

MODIFIED ADJUSTED COST RECOVERY SYSTEM (MACRS)

IRC Sec. 167(a) provides a depreciation allowance for exhaustion and wear and tear of property used in a trade or business or held for production of income. The depreciation deduction provided by IRC Sec. 167(a) for tangible property placed in service after 1986 generally is determined under IRC Sec. 168, Modified Accelerated Cost Recovery System (MACRS).

MACRS prescribes two methods for determining depreciation allowances, including the general depreciation system (GDS) in IRC Sec. 168(a) and the alternative depreciation system (ADS) in IRC Sec. 168(g).

A taxpayer generally must use GDS unless the taxpayer is specifically required to use ADS or elects to use ADS. Under either depreciation system, a depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

MACRS Planning

Practitioners often strive to obtain the largest amount of depreciation and amortization on a client's tax return. However, this is not always the best course of action. Tax planning should not be done in a single year vacuum, but with a look to both the past and the future.

The value of a tax deduction is based both on a taxpayer's marginal tax bracket and location within that bracket. Many start-up businesses and other growth-oriented businesses may be well served by saving deductions for future years. However, this section generally focuses on obtaining the maximum deduction for a taxpayer. A practitioner needs to evaluate using alternate methods when proper tax planning so dictates.

EXAMPLE: MACRS planning

During the year, Bobby, a sole proprietor truck driver, purchases a new truck for $52,000 (not a luxury automobile) and expects a $100,000 initial year of operation net loss prior to any depreciation deduction.

Bobby has several choices of how to depreciate the truck. First, he could elect IRC Sec. 179, but it would be disallowed and carried over due to the income limitation. However, this could still be an excellent choice if he was confident at the time the return is filed that he was going to have substantial income the next year with little or no new asset purchases. The truck's cost could be deducted over two years, which is much quicker than the six years it would otherwise take to fully depreciate under MACRS.

Second, Bobby might choose five-year MACRS depreciation, including bonus depreciation. This method would give the business its largest possible deduction in the current year, the full $52,000 with 100% bonus depreciation. This would be an excellent choice if Bobby is in a high individual tax bracket and a loss from his sole proprietorship would help reduce his tax liability in the current year.

Finally, Bobby can elect out of bonus depreciation and choose the ADS straight-line method if he wishes to preserve depreciation expense for later years. In other words, defer the deduction for later years when he may be in a higher tax bracket and thereby derive more bang for his buck.

Depreciation Periods and Conventions

GDS contains 10 property classes, based on the recovery period of an asset (3, 5, 7, 10, 15, 20, 25, 27.5, 39, or 50 years). Applicable depreciation methods include a 200% double declining balance method, 150% declining balance method, and straight-line method. However, 27.5-year property (residential rental property), 39-year property (non-residential real property), and certain 15-year property must be depreciated using straight-line.

ADS must be used for listed property used 50% or less for business, tangible property used predominantly outside the United States, and certain other categories of property not relevant here.

NEW DEVELOPMENT: In Rev. Proc. 2019-8, the IRS has provided guidance on deduction expenses under the ADS of IRC Sec. 168(g). Specifically, the guidance explains how real property trades or businesses or farming businesses, electing out of the IRC Sec. 163(j) interest deduction limit, change to the ADS for property placed in service before 2018, and provides that it is not a change in accounting method. In addition, the guidance provides an optional depreciation table for residential rental property depreciated under the ADS with a 30-year recovery period.

For purposes of either GDS or ADS, there are three possible conventions: half-year, mid-month, and mid-quarter conventions:

1. The half-year convention applies to property other than residential rental property, and nonresidential real property. The recovery period begins or ends on the midpoint of the tax year that the property is placed in service or disposed of.

2. The mid-month convention applies to residential rental property and nonresidential real property. The recovery period begins or ends on the midpoint of the month that the property is placed in service or disposed of.

3. The statutory mid-quarter convention applies to property (other than residential and nonresidential real property) when more than 40% of the aggregate bases of such property is placed in service during the last three months of the tax year. Under this convention, recovery periods for all property placed in service or disposed of during any quarter of a tax year begin on the midpoint of the quarter.

NOTE: Under all conventions, a depreciation deduction is not allowed for property placed in service and disposed of in the same tax year.

Choosing the Proper (Shortest) MACRS Life

Although the author is a proponent of the efficiencies of computer software, the proper asset class and MACRS life should be selected by the tax professional and not by a tax program's depreciation wizard. Most MACRS lives can be found in Rev. Proc. 87-56 under the column headed "General Depreciation System."

Rev. Proc. 88-22 modifies Rev. Proc. 87-56, but only for a few asset classes. Asset classes beginning with 00 override other more specific asset classes (e.g., Class 00.11 Office Furniture, Fixtures, and Equipment takes precedence over Class 57.0 Distributive Trades and Services). Asset class 57.0, with its 5-year MACRS life is likely the asset class most underused by practitioners. Many practitioners use a 7-year life when they could be using a shorter 5-year life. Class 57.0 "includes assets used in wholesale and retail trade, and personal and professional services." (Rev. Proc. 87-56)

PRACTICE TIP: Keep copies of both Revenue Procedures handy and highlight asset classes which are used most often so they are easier to find.

Residential rental property has a recovery period of 27.5 years for GDS and 30 years for ADS (changed in 2018 from 40 years by the TCJA). Nonresidential real property has a recovery period of 39 years for GDS and 40 years for ADS.

BONUS DEPRECIATION—IRC SEC. 168(k)

The TCJA completely changed bonus depreciation under IRC Sec. 168(k), increasing it to 100% (full expensing) for property placed in service after September 27, 2017, with a phase-out schedule.

The TCJA eliminates the requirement that original use of the property must begin with the taxpayer, so both new and used property now qualify for bonus depreciation. Instead, it must now must either meet the original use requirement or the acquisition requirement [IRC Sec. 168(k)(2)(A)(ii)].

Previous use is defined as having a depreciable interest in the property at any time prior to such acquisition, whether or not the taxpayer or predecessor claimed depreciation deductions for the property [Prop. Reg. §1.168(k)-2(b)(3)(iii)(B)(1)].

EXAMPLE: Determining Bonus depreciation treatment

Manu buys a new machine for $35,000 from an unrelated party for use in Manu's trade or business. On July 1, 2020, Freddy buys that machine from Manu for $20,000 for use in Freddy's trade or business. On October 1, 2020, Freddy makes a $5,000 capital expenditure to recondition the machine. Freddy did not have any depreciable interest in the machine before acquiring it on July 1, 2020.

Manu's purchase price of $35,000 satisfies the original use requirement and, assuming all other requirements are met, qualifies for Bonus depreciation.

Freddy's purchase price of $20,000 does not satisfy the original use requirement, but it does satisfy the used property acquisition requirement. Assuming all other requirements are met, the $20,000 purchase price qualifies for the bonus depreciation deduction. Further, Freddy's $5,000 expenditure satisfies the original use requirement and, assuming all other requirements are met, qualifies for the bonus depreciation deduction, regardless of whether the $5,000 is added to the basis of the machine or is capitalized as a separate asset.

If a taxpayer initially acquires a partial depreciable interest in a portion of property and subsequently acquires an additional portion of the same property, such additional depreciable interest is not treated as used by the taxpayer at any time prior to its acquisition by the taxpayer [Prop. Reg. §1.168(k)-2(b)(3)(iii)(B)(2)].

Property does not meet the acquisition requirement if it is—

1. Received as a gift or from a decedent,
2. Acquired in a nontaxable exchange such as a reorganization,
3. Acquired from a member of the taxpayer's family, including a spouse, ancestor, or lineal descendant, or from another related entity, or
4. Acquired from a person who controls, is controlled by, or is under common control with a taxpayer.

The TCJA extends bonus depreciation through December 31, 2026, and aircraft and long-production-period property through December 31, 2027. Bonus depreciation is available as follows [IRC Sec. 168(k)(6)]:

Portion of Basis of Qualified Property Acquired after September 27, 2017		
	Bonus Depreciation Range	
Year Placed in Service	General Qualified Property	Longer Production Property and Aircraft
9/28/2017–12/31/2022	100%	100%
2023	80%	100%
2024	60%	80%

Portion of Basis of Qualified Property Acquired after September 27, 2017		
	Bonus Depreciation Range	
Year Placed in Service	**General Qualified Property**	**Longer Production Property and Aircraft**
2025	40%	60%
2026	20%	40%
2027	None	20%
2028 and thereafter	None	None

Taxpayers may also elect out of IRC Sec. 168(k) completely, but only on an asset class by asset class basis and not by specific asset. To elect out completely, an election must be made to elect out of all asset classes.

EXAMPLE: Bonus depreciation options for assets with different MACRS lifespans

During the year, a taxpayer acquires three assets with a 5-year MACRS life and two assets with a 7-year MACRS life. Absent an election, all assets are subject to Section 168(k) bonus depreciation. A taxpayer may elect out of IRC Sec. 168(k) for all three items with a 5-year life, for the two items with 7-year life, or for all five items. However, they cannot pick and choose to elect out of only certain items in each class life.

OBSERVATION: Making an election requires careful analysis, especially considering the 20% QBID. IRC Sec. 168(k) could result in reducing income which otherwise might be eligible for the QBID. Also, IRC Sec. 168(k) could create a loss resulting in negative QBI that is carried forward to reduce QBI in subsequent years.

To be *qualified bonus property*, property must be in one of the following categories [IRC Sec. 168(k)(2)(A)]:

1. Property to which IRC Sec. 168 applies (i.e., MACRS property) and with a recovery period of 20 years or less.

2. Computer software [as defined in IRC Sec. 167(f)(1)(B)] deductible under IRC Sec. 167(a) (i.e., not self-developed computer software amortized under IRC Sec. 197).

3. Water utility property depreciated under the MACRS rules.

The TCJA further expanded the definition of *qualified property* to include qualified film, television, and live theatrical productions [IRC Sec. 168(k)(2)(A)(i)].

TECHNICAL CORRECTION: The TCJA introduced a new definition of property that replaced qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property with qualified improvement property (QIP). Unfortunately, due to a technical glitch, QIP was not listed as 15-year property and was accordingly not eligible for 15-year depreciation or bonus depreciation. However, QIP was still eligible for Section 179 expensing.

The CARES act corrected this glitch by making QIP 15-year property, and therefore bonus eligible. Please see Rev. Proc. 2020-25 and Gear Up's *Business Entities* manual for more information on how to address and implement these changes.

There are no AMT adjustments for any property using bonus depreciation.

Qualified property does not include any of the following categories:

1. Property placed in service and disposed of in the same tax year.
2. Property converted from business use to personal use in the tax year acquired. Property converted from personal use to business use in the tax year acquired may be qualified property [Reg. §1.168(k)-1(f)(6)(iii)].
3. Property required to be depreciated under the alternative depreciation system (ADS), including listed property used 50% or less in a qualified business use.
4. Property for which a taxpayer elected not to claim bonus depreciation.

The following property is not qualified property if used in [IRC Sec. 168(k)(9)]—

1. Electrical energy, water, or sewage disposal services,
2. Gas or steam through a local distribution system,
3. Transportation of gas or steam by pipeline, and
4. Certain businesses that have floor plan financing indebtedness.

SECTION 179 DEDUCTION LIMIT AND QUALIFYING PROPERTY PHASE-OUT THRESHOLD

EXAMPLE: Section 179 Deduction Limit and Qualifying Property Phaseout Threshold			
	2021	**2020**	**2019**
Limit-overall	$1,050,000	$1,040,000	$1,020,000
Qualifying property phase-out threshold	$2,620,000	$2,590,000	$2,550,000
Source:	*Rev. Proc. 2020-45*	*Rev. Proc. 2019-44*	*Rev. Proc. 2018-57*

The Section 179 deduction limit for years beginning in 2018 is increased by the TCJA to $1,000,000 and inflation adjusted in $10,000 increments beginning in years beginning after 2018 [IRC Secs. 179(b)].

IRC Sec. 179 allows taxpayers to make an election to deduct all or part of the cost of certain qualifying property in the year placed in service instead of taking depreciation deductions over a specified recovery period. The election is made by claiming the deduction on Form 4562. There is no AMT adjustment for property expensed under IRC Sec. 179.

The 2015 PATH Act made permanent the temporary provision allowing a taxpayer to make, change, or revoke an election under IRC Sec. 179. A revocation, once made, is irrevocable [IRC Sec. 179(c)(2)].

EXAMPLE: Effect of revoking a Section 179 expense election

Oops, Inc., an S corporation, elected to use Section 179 expensing on its tax return. Later the Company amended its return when it realized that their retired 80% shareholder without earned income was required to reduce his stock basis for the Section 179 deduction he was unable to use. Oops, revoked the election on the amended return.

Note: Once made, the change in the Section 179 deduction is irrevocable.

When calculating the amount of Section 179 expense allowed, there are two additional limitations:

1. For individual taxpayers, the total cost that can be deducted is limited to taxable income from the active conduct of any trade or business, including Form W-2 income [IRC Sec. 179(b)(3)(A)]. For business taxpayers, the total cost that may be deducted is limited to taxable income from the active conduct of any trade or business during the tax year (adding back shareholder salaries in an S corporation). In the case of pass-through entities, the limit applies at both the individual and pass-through level.

2. Section 179 expense must be reduced by $1 for every dollar of Section 179 asset purchase that exceed certain thresholds. This amount was increased by the TCJA to $2.5 million for 2018 and inflation adjusted in $10,000 increments thereafter. The limit is $2.62 million for 2021.

NEW DEVELOPMENT: The TCJA expanded the definition of *Section 179 property* to include tangible personal property used predominantly in furnishing lodging or in connection with the furnishing of lodging. This includes beds and other furniture, refrigerators, ranges, and other equipment used in a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided.

New or used tangible personal property qualifies under IRC Sec. 179. However, leased property usually does not qualify [IRC Sec. 179(d)(5)].

LISTED PROPERTY

Listed property includes certain items that lend themselves to personal use by a taxpayer. To be able to depreciate such property, the IRS requires a taxpayer to substantiate and document business use of the asset. The depreciation is reported in Part V, on page 2, of Form 4562, along with substantiation disclosures.

Listed property includes—

1. Passenger automobiles.

2. Any property used for transportation, such as trucks, buses, boats, airplanes, and motorcycles.

3. Property used for entertainment, recreation, or amusement.

Exceptions to classification as listed property include—

1. Vehicles not likely to be used more than a minimal amount for personal purposes (e.g., tow truck, ambulance, utility vehicle).

2. Any vehicle designed to carry cargo and has a loaded gross vehicle weight over 14,000 pounds (e.g., cement mixer, dump truck, moving van).

LUXURY AUTOMOBILES

The IRS issued the 2021 limitations on depreciation for owners of passenger automobiles placed into service during 2021 in Rev. Proc. 2021-31. Included in the term passenger automobiles are light trucks and vans.

Luxury passenger automobiles are defined as any passenger automobile, truck, van, or SUV with a gross vehicle weight of 6,000 pounds or less, with an original cost (for 2021) of at least $51,000 [Rev. Proc. 2021-31]. Luxury automobiles are subject to the listed property reporting requirements discussed previously.

The TCJA more than tripled the depreciation limitations under IRC Sec. 280F, and they have been indexed for inflation for 2021 for luxury automobiles as follows [Rev. Proc. 2021-31]:

Passenger Auto Limits for 2021		
	With Bonus Depreciation	**Without Bonus Depreciation**
1st Year	$18,200	$10,200
2nd Year	$16,400	$16,400
3rd Year	$9,800	$9,800
Each Succeeding Year	$5,860	$5,860

For passenger automobiles eligible for 100% first-year bonus depreciation, the maximum additional first-year depreciation allowance remains at $8,000.

EXAMPLE: Depreciation treatment of passenger automobile

Timmy buys a used automobile from an unrelated seller for $51,000 and places it in service during 2020. The auto is used 100% for business purposes. Timmy can take depreciation up to $10,200. In addition, even though this is a used vehicle, he can take $8,000 of first-year bonus depreciation for a total of $18,200.

If the auto is not used 100% for business purposes, the total deduction is reduced proportionately.

Straight-line depreciation under the alternative depreciation system (ADS) must be used if business use of a vehicle is 50% or less [IRC Sec. 280F(b)(1)].

Depreciation deduction recapture rules apply when business use of listed property falls below the more-than-50% test.

SUV Limit

Certain heavy passenger vehicles are subject to a $26,200 for 2021, $25,900 for 2020 limit (per vehicle) for the Section 179 deduction [IRC Sec. 179(b)(5)(A); Rev. Procs. 2019-44 and 2018-57].

EXAMPLE: SUVs subject to 280F Limitation Amount That Can Be Expensed Under IRC 179

	2021	**2020**
SUVs	$26,200	$25,900

The SUV limit is not prorated for business use of the vehicle. This limit applies to certain four-wheeled vehicle primarily designed to carry passengers over public streets, roads or highways. Trucks and vans with a loaded GVW of more than 6,000 pounds and that are rated at no more than 14,000 pounds GVW are subject to the SUV expense limit. Also, autos with an unloaded weight over 6,000 pounds that are rated at 14,000 pounds GVW or less are subject to the limit.

NOTE: Several popular SUVs are heavy enough to be rated for gross vehicle weight in excess of 6,000 pounds (e.g., Chevrolet Suburban, Toyota Land Cruiser) (Ltr. Rul. 9520034). Some common websites such as **www.kbb.com** and **www.carsdirect.com/research**, can be used to look up a vehicle’s weight.

Vehicles Excepted from SUV Limits

Some vehicles weighing between 6,000 and 14,000 can be fully depreciated. Vehicles meeting the following standards are exceptions to the SUV limit and will qualify for the full Section 179 allowance as long as they have gross vehicle weight ratings in excess of 6,000 pounds. To escape the SUV limit, the vehicle must—

1. be designed to seat more than nine passengers behind the driver's seat (e.g., a hotel shuttle van);
2. have an open cargo area or covered box not readily accessible from the passenger compartment of at least six feet in length (e.g., many pickups with full-size cargo beds); or

3. have an integral enclosure that fully encloses the driver compartment and load carrying device, does not have seating behind the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield (e.g., a delivery van) [IRC Sec. 179(b)(5)(B)].

NOTE: Even though heavy sport utility vehicles may be outside the passenger automobile definition, they are property used as a means of transportation. Therefore, they are still within the IRC Sec. 280F(d)(4) definition of “listed property” and are subject to the business usage substantiation rules.

New Vehicles Added for Plug-in Vehicle Credit

IRC Sec. 30D(a) provides a credit to the purchaser of a qualified plug-in electric drive motor vehicle, including passenger vehicles and light trucks. The credit allowed is limited to $2,500 plus an additional amount, based on battery capacity, that cannot exceed $5,000. The credit phases out over six calendar quarters beginning when a manufacturer has sold at least 200,000 qualifying vehicles in the U.S. Recently, the IRS added the following models to its list of vehicles eligible for the credit:

- 2021 Ford Mustang Mach-E GT,
- 2021 Hyundai Ioniq Plug-In Hybrid Electric Vehicle and Ioniq Electric Battery Vehicle,
- 2021 Porsche—
  - Cayenne/Cayenne Turbo S E-Hybrid and E-Hybrid Coupe,
  - Panamera 4 PHEV (which includes the 4 E-Hybrid, 4 E-Hybrid Sport Turismo, 4 S E-Hybrid, 4 S E-Hybrid Sport Turismo, 4 E-Hybrid Executive, Turbo S E-Hybrid, and Turbo S E-Hybrid Sport Turismo).

For a full list of vehicles, visit **www.irs.gov/businesses/irc-30d-new-qualified-plug-in-electric-drive-motor-vehicle-credit** .

Alternative Fuel Vehicle Refueling Property Credit

The Setting Every Community Up for Retirement Enhancement Act (SECURE Act) extended this credit through 2020. Later “The Taxpayer Certainty and Disaster Relief Act of 2020 (TCDTR) which was part of the Consolidated Appropriations Act of 2021 extended to property placed in service before January 1, 2022. A 30% credit is available property used to store or dispensed clean-burning fuel or to recharge electric vehicles for use in the taxpayer’s trade or business up to a maximum of $30,000. In addition, a credit of up to $1,000 for qualifying property installed at the taxpayer’s principal residence.

Claiming Vehicle Deductions and Credits

Self-employed taxpayers filing a Schedule C for their business activity claim vehicle expenses on Schedule C, whether using the standard mileage rate method or claiming actual vehicle expenses.

If actual expenses are claimed and depreciation is allowable, IRS Form 4562 (Depreciation and Amortization) must be completed. If a self-employed taxpayer claims a depreciation deduction on Schedule C for car or truck expenses, part or all of page 2 of Form 4562 must be completed. Taxpayers must complete Form 4562, Part V, Section A, for all passenger cars for which a depreciation deduction is claimed; Section B must be completed by sole proprietors who use a vehicle in their business or who provide vehicles to employees, whether or not a depreciation deduction is claimed.

Sole proprietors claiming expenses related to a business vehicle may use Schedule C, Part IV, rather than Form 4562, if they are using the standard mileage rate, leasing the vehicle, or it is fully depreciated (i.e., there is no current-year depreciation deduction).

EXAMPLE: Depreciation limits when a luxury car is used for business and personal use.

In 2020, Tim purchased a new car costing $65,000 for use in his sole proprietorship. The car is used 90% for business in 2020, but only 80% for business in 2021 and 2022. Thereafter, it is used 90% for business. Tim uses a half-year convention and the MACRS depreciation method. Because of the vehicle's cost, the Section 280F limits apply each year.

Depreciation is calculated as follows:

- 2020: $9,090 ($10,100 × 90%);
- 2021: $12,880 ($16,100 × 80%);
- 2022: $7,760 ($9,700 × 80%);
- 2023–2027: $5,184 each ($5,760 × 90%); and
- 2028: 270 ($300 remaining deductible basis × 90%).

The difference between the deductible depreciation of $55,920 and the original $65,000 cost is $9,080. This amount represents the personal use portion of the car's tax basis for 2020–2028. This amount can never be deducted.

EXAMPLE: Reporting standard mileage rate method by a proprietor

John is a self-employed consultant whose only office is in his residence. This home office qualifies as John's principal place of business. His vehicle log reflects 70% business use of his auto (the total mileage for the year was 14,100 miles, of which 9,870 were for business). John maintains written evidence of his business mileage and uses the standard mileage rate method of deducting vehicle expenses. John is allowed to complete Schedule C, Part IV, rather than using Form 4562, because of his use of the standard mileage rate method.

Standard Mileage Rate versus Actual Expenses

The standard mileage rate method is $ .56 per mile for business use in 2021 down from the previous $ .575 used in 2020. Generally, a taxpayer may use the method that generates the largest deduction (either the standard mileage rate method or the actual cost method).

The standard mileage rate method is subject to the following limitations:

1. The standard mileage rate cannot be used if the vehicle has been previously depreciated using a method other than straight-line. Stated differently, use of MACRS or the Section 179 deduction will preclude conversion to the standard mileage rate in a later year.

2. The taxpayer may change from the standard mileage rate method to the actual cost method, but must then use straight-line depreciation for the vehicle's estimated useful life (subject to the luxury auto limits of IRC Sec. 280F). If the standard mileage rate method is used for leased vehicles, it must be used for the entire term of the lease. The standard mileage rate can be used for leased vehicles, as well as purchased autos, beginning in 1998 and for later years (Rev. Proc. 2010-51).

3. The standard mileage rate may not be used if a taxpayer uses five or more vehicles simultaneously in a trade or business. However, if a taxpayer uses different vehicles for different periods during the year, the standard mileage rate can be applied to the total business miles of both vehicles as if they were one.

The standard mileage rate is a substitute for depreciation, maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and registration fees. However, parking fees and tolls attributable to business use of the vehicle may be deducted as separate items. Likewise, business interest attributable to the purchase of the automobile, as well as state and local taxes (other than gasoline taxes), may be deducted separately, but only to the extent otherwise allowable under IRC Sec. 163 for interest and IRC Sec. 164 for taxes.

Example: Additional expenses with the standard mileage rate method

Bob is a sole proprietor who uses an auto in his business. Bob drives his vehicle approximately 25,000 total miles per year and is able to document 20,200 miles as driven for business purposes (81% business use). Bob paid $1,200 of interest expense to GMAC in connection with this vehicle and incurred $500 of business-related tolls and parking fees. If Bob claims the standard mileage rate method for 2021, his deduction for vehicle expense would be calculated as follows:

Business mileage (20,200 × $ .56)	$ 11,312
Toll and parking fees for business	500
Interest expense ($1,200 × 81% business use)	972
Total Schedule C vehicle deductions	$ 12,784

The standard mileage method reduces the record keeping burden it is ideal for self-employed taxpayers who wish to minimize automobile recordkeeping duties even at the risk of smaller deductions.

OBSERVATION: Before deciding on the standard mileage rate method or actual expense method, taxpayers should project mileage and actual operating costs, including depreciation, over period they intend to use the vehicle. Using the standard mileage method will prevent any Section 179 deduction in the first year and any MACRS (accelerated) depreciation in later years if the taxpayer afterward decides to switch to the actual cost method.

Effect of Standard Mileage Method on Vehicle Basis

Annually, the IRS publishes the deemed depreciation rate that is considered to reduce the basis of a vehicle for which the standard mileage rate method is claimed. The following table summarizes the basis adjustment that occurs per mile of business use for recent years:

Year	Deemed Depreciation per Mile
2021	$ .26
2020	$ .27
2019	$ .26
2018	$ .25
2017	$ .25
2016	$ .24
2015	$ .24
2014	$ .22
2012 and 2013	$ .23
2011	$ .22

EXAMPLE: Adjusting vehicle basis for standard mileage rate method.

Bob has been using the standard mileage rate method for the business deductions on his vehicle for 2021 and 2020. Assume that Bob's business and total mileage were the same each year and that the original cost of the vehicle was $20,000. The basis as of December 31, 2021, is computed as follows:

	Total	81% Business	19% Personal
Original cost or basis	$ 20,000	$ 16,200	$ 3,800
Less deemed depreciation at			
$ .26 per mile for 2021 (20,200 business miles)		(5,252)	
$ .27 per mile for 2020 (20,200 business miles)		(5,454)	
Adjusted basis—business portion		$ 5,494	

Leasing Business Autos

Automobile leases have certain advantages. They require a minimal investment and are convenient if the customer replaces the car every two or three years. Leases are normally worth considering if the lease customer does not intend to drive the car beyond the end of the lease term and wants to minimize his cash outlay. However, the lease customer also must be prepared to maintain the car and stay within the mileage allowance; otherwise, the customer will be charged for excess wear and tear and mileage when the car is turned in.

When a taxpayer leases an auto and uses it in a trade or business, the business use percentage of the lease expense can be deducted if the actual cost method for claiming auto expenses is used. However, to achieve approximate parity with the depreciation limitations that apply to owned luxury cars, the IRS releases an annual table of leased “income inclusion” amounts that apply to luxury cars leased for 30 days or more. The annual income inclusion amount is subtracted from the lessee's lease expense for the year to determine the net deduction for the year [IRC Sec. 280F(c)(2)]. The deductions of the car's owner (the lessor) are not affected by this adjustment [IRC Sec. 280F(c)(1)].

The income inclusion amounts vary depending on the FMV of the car. For cars first leased in 2021, the income inclusion rules apply when the car's FMV exceeds $51,000. The income inclusion table for cars first leased in 2020 is published in Rev Proc. 2021-31. Due to TCJA related increases in the luxury auto limits, the income inclusion for autos leased after 2017 has been greatly reduced.

NOTE: The FMV of the leased auto is the amount that would be paid to buy the car in an arm's length transaction. The FMV for the leased income inclusion rules is the capitalized cost of the auto, if that cost is specified in the lease agreement [Temp. Reg. 1.280F-5T(h)(2)]. If the capitalized cost is not furnished in the lease agreement, the leasing customer might refer to a publication (such as the NADA book) or a database that reports new or used car retail prices.

EXAMPLE: Calculating the lease income inclusion amount

On January 19, 2021, Jack leased a car for three years and placed it in service in his sole proprietorship business. The car had an $58,500 FMV on the first day of the lease term. The car is used 75% for business. The lease income inclusion amount for 2021 is $2 (table amount of $3 from Rev Proc. 2021-31, prorated for 75% business use and 347/365 days of the year). For 2021, the second year of the lease, the income inclusion amount will be $4 (table amount of $5 from Rev Proc. 2020-37 × 75% business use).

Note: The lease inclusion amount is avoided if the standard mileage rate is used.(Rev. Proc. 2010-51).

Commuting Expenses from a Home Office

Ordinary and necessary transportation expenses are deductible if incurred for business purposes [IRC Sec. 162(a)]. The IRS has long agreed this includes the daily costs of going between two specific business locations, whether in the same or different businesses (Rev. Proc. 2019-46).

However, the deductibility of the costs of commuting from a taxpayer's personal residence to work locations has been subject to continuous dispute. IRS guidance on this issue is found in Rev. Ruls. 94-47 and 99-7. The guidance distinguishes between taxpayers who maintain a qualifying home office and taxpayers who do not.

THE LEASE INCOME INCLUSION RULE FOR LUXURY AUTOS

Deducting Local Transportation When Taxpayer Maintains a Home Office

Self-employed taxpayers whose residences qualify as their principal places of business under IRC Sec. 280A(c)(1)(A) can deduct local transportation expenses incurred in going between their residence and other work locations in the same trade or business, including regular or temporary work locations and regardless of the distance (Rev. Rul. 99-7).

> **EXAMPLE: Home office eliminates commuting expense**
>
> Jack is a self-employed management consultant for a variety of small businesses. He maintains a home office used regularly and exclusively to set up appointments, store client files, and develop management reports for his business clients. Jack has no other office location other than his residence for these administrative duties of his business. He routinely uses his personal auto traveling from his home to meet with prospective and current business customers or their representatives. His home office qualifies as his principal place of business under IRC Sec. 280A(c)(1)(A). Because Jack meets the principal place of business home-office criteria, his mileage traveling from his residence to see clients, to work at other regular or temporary work locations, or to perform other business duties is deductible business use.

Commuting by Taxpayer without Home Office

In Rev. Rul. 94-47, the IRS clarified its position on the deductibility of transportation to temporary work locations by self-employed taxpayers not maintaining a home office [under the IRC Sec. 280A(c)(1)(A) principal place of business home-office criteria]. Although reiterating that daily transportation expenses incurred when going between the taxpayer's residence and a work location are normally nondeductible, it identified two situations in which the transportation costs of commuting to temporary work locations are deductible. These rules were then amplified by the IRS in Rev. Rul. 99-7.

1. <u>No Established Work Location.</u> If a taxpayer regularly works in a particular metropolitan area, but not at any specific work location within the metro area (i.e., has no regular places of work), the commute between the taxpayer's personal residence and a temporary work location within the metro area is personal use. However, the commute between the taxpayer's personal residence and a temporary work location outside the metro area is business use. (See *Wheir* in following Court Case alert.)

2. <u>Established Work Location.</u> If the taxpayer does not meet the principal place of business home-office criteria under IRC Sec. 280A(c)(1)(A), but has one or more regular work locations, the following rules apply (regardless of whether the taxpayer regularly works in a particular metropolitan area and regardless of distance):

    a. The commute between the taxpayer's personal residence and a regular work location (inside of or outside of the metro area) is personal use.

    b. The commute between the taxpayer's personal residence and a temporary work location in the same trade or business (inside of or outside of the metro area) is business use.

COURT CASE: In *Wheir*, the Tax Court disagreed with the interpretation of the IRS given to a metropolitan area, finding that Rev. Rul. 99-7 does not define the term metropolitan area. The IRS had attempted to disallow travel expenses for the taxpayer for jobs greater than 35 miles from his home, arguing that a larger area represented a metropolitan area. However, the court determined that assignments more than 35 miles from his home were outside of the immediate metropolitan area, allowing deductibility of the travel expenses for the taxpayer.

A regular work location is any location where the taxpayer works or performs services on a regular basis. The IRS has ruled that if employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise (Rev. Rul. 99-7). If employment at a work location is realistically expected to last for more than one year or there is no realistic expectation that the employment will last for one year or less, the employment is not temporary, regardless of whether it actually exceeds one year. If employment at a work location initially is realistically expected to last for one year or less, but at some later date the employment is realistically expected to exceed one year, the employment is treated as temporary, in the absence of facts and circumstances indicating otherwise, until the date that the taxpayer's realistic expectation changes, and is treated as not temporary after that date.

302.41 Accordingly, Rev. Rul. 99-7 consistently follows the one-year rule of a temporary work location used in the “travel away from home” rules (for meals and lodging purposes) previously described by the IRS in Rev. Rul. 93-86. However, the Tax Court allowed a self-employed consultant to deduct his travel costs, including meals and apartment rentals, in a situation dealing with a single client that spanned a five-year period (Thomas J. Mitchell, et ux. v. Commissioner, TC Memo 1999-283). The taxpayer worked for a number of clients and looked for other work associated with other clients while working with the company over which the efforts spanning the five-year period occurred; accordingly, the court failed to impose the “indefinite” criteria of Rev. Rul. 93-86, concluding that “merely because an independent contractor may return to the same general location in multiple years. (*Corey L Wheir v. Comm.*, TC Summary Opinion 2004-117)

EXAMPLE: Sole proprietor with regular work locations but no home office

Susan Thomas, a sole proprietor, owns and operates a travel agency with three branch locations throughout the city. She spends approximately 10–15 hours a week in a room at her house used exclusively for her business. Susan spends 30–35 hours per week at the three branch locations. Susan's office at home does not qualify as a home office under the IRC Sec. 280A(c)(1)(A) criteria.

Susan's travel between her residence and any of the three branch locations where she regularly works represents commuting and is not deductible. However, if Susan's work takes her temporarily to another location to meet with a business associate (whether inside or outside of the metro area), the travel from her residence to that location would be deductible. Also, Susan may deduct any transportation between the three branch locations where she regularly works on a given day (Rev. Rul. 55-109).

OBSERVATION: The IRS Chief Counsel's office issued a number of advisory memorandums that further interpret Rev. Rul. 99-7 and the deductibility of transportation expenses to temporary work locations (CCAs 199948016, 199948018, 199948019, 200018052, 200025052, and 200026025). These rulings provide guidance in areas such as breaks in temporary engagements and occasional work at a non-temporary worksite.

CAUTION: The IRS will impose penalties if it determines, upon examination, that a clear pattern of abuse by the taxpayer exists in claiming business use for daily transportation in going between the taxpayer's residence and asserted temporary work locations without proof of a valid business purpose (Rev. Rul. 90-23).

WHERE TO GO FOR MORE INFORMATION

- Checkpoint's Federal Tax Compliance Library—
  - *PPC's 1040 Deskbook*
- Checkpoint's Tax and Financial Planning Library—
  - *PPC's Guide to Self-Employed Individuals*
  - *PPC's Guide to Tax Planning for High Income Individuals*
- IRS Publication 463, *Travel, Gift and Car Expenses*
- IRS Publication 535, *Business Expenses*
- IRS Publication 946, *How to Depreciate Property*

CHAPTER 31: EMPLOYER RETIREMENT PLANS

Learning Objectives

Completion of this chapter will enable participants to

- Aid clients in selecting the appropriate retirement savings vehicle
- Correctly calculate self-employed retirement contributions

THINKING BEYOND THE DEDUCTION

Most of those blessed with longevity will live beyond their working lives. Now this does not mean older individuals cannot continue to work or make valuable contributions their entire lives. It does mean expecting to fund retirement by working one's entire life is statistically unrealistic. On average, 4 in 10 workers will be forced to retire because of health issues.

U.S. Census Bureau data indicate the average retirement age for US workers is age 65 for men and 63 for women. According to the National Center for Health Statistics, the average remaining expected life (as of 2018) for an individual who has attained age 65 is 19.5 years (men average 18.1 years; women average 20.7 years). Statistically, someone retiring at age 65 has a 76% chance of living 10 or more years, a 38% chance of living more than 20 years, and a 5% chance of living 30 or more years. Given that these are averages for the entire population, it may not be unreasonable for those in good health who have access to adequate healthcare to live 30 or more years in retirement. Essentially, most workers have anywhere between 40 and 45 years to fund a retirement that may last 30 years.

While most clients, especially the wealthy, understand the need to fund retirement, many continue to look at retirement savings as something they can put off or, worse, just as a tax savings mechanism. Not realizing a systematic savings system and the time value of money is their biggest ally in achieving a comfortable retirement.

HOW MUCH IS NEEDED FOR RETIREMENT?

Rules of thumb provide a quick initial assessment. However, while helpful, they are not the basis of a strong financial plan. They should be thought more of as educated guesses or opinions. A true financial plan starts with client goals and objectives and must factor in current financial status, longevity, lifestyle (spending), savings timeframe, rates of return, inflation, and risk tolerance. The following guidelines are often used in a planning context:

1. <u>Save 10% of your income for retirement.</u> Automatically save 10% of your income in a systematic manner for retirement. This rule works really well for younger workers who are their early 20s, the cash need greatly increases for those who start saving later in life. (See chart that follows.) Automatic savings, however, is the key to meeting financial goals.

2. <u>4% (possibly lower) Withdraw Rule.</u> While many investors expect returns of 7% or greater, those near or in retirement cannot afford to take the risk of loss associated with higher rates of return. Many planners consider a 4% rate of return a safe rate of withdraw from a well-diversified portfolio. Using this rule, a withdraw of $40,000 on a $1 million portfolio would be considered sustainable. Unfortunately, for those clients who insist guaranteed forms of savings, guaranteed rates are currently much lower.

3. <u>80%–90% of Income Target.</u> A retirement savings that will replace 80%–90% of pre-retirement income is often mentioned in the press. However, there is a presumption that expenditures in retirement will be reduced through changes of habit or living style. It fails to recognize potential inflationary risks or required spending changes. For instance, an older couple spends less in housing because the mortgage is paid off or they downsize the residence, but they will also experience increased health costs which tend to outpace inflation. Depending on the source of the income, the taxation can vary greatly (capital gain, ordinary income, and tax-free).

4. <u>Social Security Will Replace 40% of Preretirement Income.</u> While Social Security does provide a stable monthly payment, the percentage of income it replaces varies greatly depending on the taxpayer's level of income. Social Security's benefits are skewed toward lower earning workers who may get benefits as much as 90% of their averaged indexed monthly earnings. However, for workers with average indexed monthly earnings over $6,002 (2021 bend points) the benefit drops to 15%. Earnings over the Social Security thresholds provide no additional benefit.

EXAMPLE: Monthly investment at various rates of return to save for $1 million

		Rate of Return	
# Of Years Saved	**6.00%**	**7.00%**	**8.00%**
50	$262.73	$182.49	$125.24
40	$499.64	$378.77	$284.55
30	$990.55	$814.94	$666.54
20	$2,153.54	$1,908.52	$1,686.49
10	$6,071.69	$5,744.01	$5,429.89

SMALL EMPLOYER CREDITS FOR RETIREMENT PLAN EXPENSES

To encourage small employers to adopt and maintain a qualified retirement plan, there are two nonrefundable income tax credits available for the administrative and retirement-education expenses of a small business that adopts a new qualified defined benefit or defined contribution plan [including a 401(k) plan], a SIMPLE plan, or SEP (IRC Sec. 45E). The credits do not apply to solo retirement plans.

The credits are available to an employer that did not employ, in the preceding year, more than 100 employees with compensation of at least $5,000. For an employer to be eligible for the credits, the plan must cover at least one non-highly compensated employee.

Qualified startup costs are ordinary and necessary expenses of an eligible employer which are paid or incurred in connection with (a) establishing or administrating an eligible employer plan or (b) the retirement-related education of employees with respect to the eligible employer plan (IRC Sec. 45E).

The SECURE Act expands the startup credit for setting up a new retirement plan. Beginning January 1, 2020, the credit applies to 50% of qualified startup costs, up to the greater of—

1. $500, or

2. the lesser of—

    a. $250 for each employee that is a non-highly compensated employee eligible to participate in the plan, or

    b. $5,000.

The new maximum is $15,000 over the three-year period. An additional $500 credit applies for plans with an automatic enrollment feature.

The 50% of qualifying startup expenses offset by the credit are not deductible; however, the other 50% of such expenses (along with other expenses above the annual limit) remain deductible to the extent permitted under current law. Eligible small employers claim the credit on Form 8881 (Credit for Small Employer Pension Plan Startup Costs). The credit is part of the general business credit. Any unused amounts can be carried back or forward to other tax years.

EXAMPLE: Determining amount of credit for retirement plan startup costs

Jack owns all the shares of GHI Corp. During 2021, the corporation has 15 employees and Jack decides to have the corporation establish a profit-sharing plan, effective in 2021. In 2021, GHI spends $3,000 establishing and administering the plan. In 2022, 2023, and 2024, the corporation pays $4,000 in costs of operating the plan and educating employees about the plan. GHI can take a nonrefundable credit of $1,500 in 2021 (50% × $3,000) and $2,000 in 2022 and 2023 (50% of $4,000). The limit of 50% of the expenses for each year is less than the maximum credit allowed of $3,750 (15 × $250). No credit is available in 2024 because the credit is only available for each of the first three years of the plan.

Variation: Assume the same facts. If the new plan was designed to also include an eligible automatic contribution arrangement, GHI could take the original startup credit of $1,500, plus the additional $500 credit for the EACA, for a total credit of $2,000 in 2021. In both 2022 and 2023, GHI can take a credit of $2,500 (the original startup credit of $2,000, plus the additional $500 credit for the EACA).

CHOOSING THE APPROPRIATE RETIREMENT VEHICLE

Unfortunately, not everyone is willing or able to fully maximize retirement savings opportunities. While a 401(k) allows an individual to put away $19,500 (plus catch up for those 50 or older of $6,500) a self-employed individual supporting a young family making $60,000 is highly likely to be unable to avail themselves of the full savings opportunity. Given the cost and the restrictions of the plan, it is highly unlikely the 401(k) is good fit for such an individual.

Things to consider when assisting a business with implementation of a retirement savings plan should include:

- <u>The employer's willingness to pay for plan administrative costs and burdens.</u> Most qualified plans need a plan administrator and may require annual filings. There are fees to administer and operate the plan on a day-to-day basis, as well as costs incurred in recordkeeping and in complying with reporting and disclosure requirements. Those employers opposed to such restrictions should consider using IRA based rather than qualified plans.

- The employer's willingness to accept mandatory contributions for employees. defined benefit plans, SIMPLE IRA, SIMPLE 401(k) and Safe-harbor 401(k) all require minimum funding.

- Amount that the employer is willing to contribute to the plan. The employer's ability and willingness to make contributions must be considered.

- Which employees does the employer want to benefit from the plan? While many employers want to provide a benefit to retain workers, others may want to limit coverage to themselves or to a targeted group of employees.

- The employee census. Data must be gathered for all employees including, length of service, age, and compensation. Accurate census data is an absolute must for any plan.

- What is the expectation for growth and the need for new hires?

EXAMPLE: Sample client retirement saving options

Client: ______________________________ Date: ______________

Employer Goal	Qualified Plan	SIMPLE 401(k)	SEP	SIMPLE IRA	IRA	Roth IRA
1. Maximize tax deductions	X		X	X		
2. Increase employee incentive	X					
3. Control benefit costs		X	X	X	X	X
4. Attract and retain valuable employees	X	X	X	X	X	X
5. Allow employee pre-tax deferrals	X	X		X		
6. Flexibility in making contributions	X		X		X	X
7. Minimize cost of adopting			X	X	X	X
8. Minimize administration costs		X	X	X	X	X
9. Maintain competitive benefits	X	X	X	X	X	X
10. Provide retirement vehicle for employees	X	X	X	X	X	X

Payroll Deduction IRAs

Payroll deduction IRAs are even simpler than SEPs to administer. It is a convenient way for employees to save on a regular basis. This is merely a payroll deduction and not a qualified plan. Therefore, there are no filing or nondiscrimination requirements. It allows employees to instruct the employer to automatically deposit part of their pay into their IRA account. It has the same tax advantages available to the individual employee under the normal IRA rules. The limits are the same as for a traditional IRA ($6,000 for 2021 plus an additional catch-up contribution of $1,000 for employees older than age 50 by the end of the calendar year). It is the employee's responsibility to track the limits and make any corrections for overfunding.

EXAMPLE: SOLE PROPRIETOR SAMANTHA USING AN IRA

Sam (age 24) is in her first year of her consulting business. At least initially, she is the only one working the business. She understands the importance of savings but is concerned about her budget and the ability to make contributions.

Traditional and Roth IRAs

Being age 24, Sam could put away $6,000 ($7,000 for those over age 50) into a Traditional or ROTH IRA. The advantages of IRAs include:

1. Simplicity. IRAs are easy to fund and can be established up to the due date of individual tax return. Ideally, Sam would automatically make contributions to the IRA on a weekly or monthly basis for budget purposes.

2. Amount of Contribution. Sam is eligible to make the full amount of the contribution if she has earned income of at least $6,000.

3. Flexibility. Assuming she otherwise qualifies, Sam has flexibility over how she can contribute the funds—she can make the entire contribution to deductible IRA or ROTH IRA or split the contribution between the between the two types of accounts. Assuming she is in a low tax bracket, given her age and time horizon, the ROTH IRA most likely be a better alternative.

4. Not Affected When Adding Employees. If she adds employees, she will not be required to make contributions now or in the future for their benefit.

5. Bankruptcy Protection. In the event Sam must declare bankruptcy her IRA contributions are protected in bankruptcy ($1,362,800 as of April 1, 2019). Please note inherited IRAs, SIMPLE IRA and SEP are not eligible for this exception. IRAs do not have the protection from credits provided by qualified plans.

6. Savers Credit. if Sam as a single individual has a relatively modest modified adjusted income, she may qualify for the savers credit.

Simplified Employee Pension (SEP) Plan

SEPs are a favorite last-minute tax planning tool. The plans can be established any time before the deadline for filing the taxpayer's return, including extensions. [IRC 404(h)(1)(B), Prop. Reg. 1.408-7(b)]. Unfortunately, for those with large tax liabilities, generating enough cash to pay the tax due and make the contribution is difficult even by the extended due date. This is especially true for self-employed individuals who also must cover estimated tax payments. Setting up a manageable automatic payment for plan contributions is highly advisable.

An SEP Plan is adopted by completing and signing Form 5305-SEP. The form is not filed with the IRS, but is maintained as part of the employer's permanent record. A copy of the form must be given to all participants.

Contribution Limit

For 2021 the contribution limit for a SEP is the lesser of—

1. 25% of up to $290,000 of compensation or

2. $58,000.

WARNING: For self-employed plans, the contribution limit is based on net self-employment (SE) income earned by the business. The net self-employed income is calculated after the reduction for the SEP contribution and the SE tax deduction. Generally, taxpayers pay self-employment taxes on 92.35% of their self-employed income. IRS Publication 560, *Small Business Retirement Plans*, contains a table to adjust the contribution % for the self-employed individual.

As with all IRA plans the contributions are always 100% vested.

Assume Sam's Schedule C net income is $40,000. Her maximum contribution to the plan would be $7,435. Sam still potentially could make the IRA contributions as previously discussed if she meets the requirements. Participation in the SEP would make her a plan participant for traditional IRA purposes. While she could potentially get the savers credit since the plan is a solo retirement plan it is not eligible for the retirement plan start up credit.

Sam's SEP Plan

Schedule C Net	$ 40,000
Less SE Deduction	2,826
Proprietor's earned income	$ 37,174
Max Rate	20.00%
SEP Contribution	$ 7,435

Eligibility

While the plan can have less restrictive provisions, an eligible employee is someone who at a minimum:

1. Attained age 21

2. Has performed any services for the employer during at least three of the preceding five years and

3. Has received at least $650 in compensation (2021).

Failure to cover any employee terminates the employers use of a SEP. Prop. Reg. 1.408-7(d) allows employers to overcome this problem by setting up an IRA on the employee's behalf.

EXAMPLE: Sam hires an employee

In December Year 1, Sam hirers Debbie as a part-time assistant. Debbie is age 24 and made $1,000 in wages for year one. If Sam decides to make the SEP contribution for Year 1, will she have to cover Debbie in the SEP Plan?

No, while Debbie has attained the age of 21 and has received at $650 in compensation, she does not meet the 3-out-of-5 test. If Debbie continues to work for Sam, she will qualify for contributions in Year 4.

Annual Disclosures

Each calendar year, sponsoring employers must give each participating employee a statement showing any contribution made to the employee's IRA. If the contribution is made before year-end, this requirement is satisfied by including the information on the employee's Form W-2. If the contribution is made after year-end (but before the employer's income tax return for the year is filed), the notification should be within 30 days of the contribution and should be made on a separate statement given to each participating employee [Prop. Reg. 1.408-9(b)]. Within 30 days of the effective date of any amendment to the terms of a SEP, a copy of the amendment and a clear written explanation of its effects must be given to employees.

Savings Incentive Match Plan for Employees (SIMPLE Plan)

A SIMPLE IRA plan allows employees and employers to contribute to traditional IRAs set up for employees. It is ideally suited as a start-up retirement savings plan for small employers not currently sponsoring a retirement plan. The employer must have 100 or few employees and the employer cannot have any other retirement plan.

SIMPLE IRA has the advantage of shifting the main contribution responsibility from the employer to the employee since by its nature the plan revolves around employee contributions.

The plans are easy to establish and have no filing requirement for the employer. The employer must establish a financial institution and must execute a written agreement to provide benefits to all employees.

Timing of the Setup

A SIMPLE IRA can be set up on any date from January 1 through October 1 of a year, provided the employer did not previously maintain a SIMPLE IRA plan. This requirement does not apply if you are a new employer that comes into existence after October 1 of the year the SIMPLE IRA plan is set up and is set up as soon as administratively feasible. A SIMPLE IRA plan cannot have an effective date that is before the date you actually adopt the plan.

The employer can use either the Form 5304-SIMPLE or the Form 5305-SIMPLE. The Form 5304 is used if the employer wants the employees to select the financial institution to receive their contributions. The Form 5305 the employer chooses the financial institution.

Annual notice

The employer must notify each employee before the beginning of the election period of—

1. The employee's opportunity to make or change a salary reduction choice under the SIMPLE IRA plan.
2. The employees' ability to select a financial institution that will serve as trustee of the employees' SIMPLE IRA, if applicable.
3. The decision to make either matching contributions or nonelective contributions.
4. A summary description (the financial institution should provide this information); and
5. Written notice that the employee can transfer his or her balance without cost or penalty if you are using a designated financial institution.

The election period is generally the 60-day period immediately preceding January 1 of a calendar year (November 2nd–December 31st). However, the dates of this period are modified if setting up a SIMPLE IRA plan in mid-year or if the 60-day period falls before the first day an employee becomes eligible to participate in the SIMPLE IRA plan.

If setting up a SIMPLE IRA plan using either Form 5304-SIMPLE or Form 5305-SIMPLE, an employer can give each employee a copy of the signed forms to satisfy the notification requirement.

Withdraws, Rollovers, and Loans

SIMPLE IRA contributions and earnings can be withdrawn at any time, subject to the general limitations imposed on traditional IRAs. A withdrawal is taxable in the year received. If a participant makes a withdrawal before attaining age 59½, generally a 10% additional tax applies. If this withdrawal occurs within the first two years of participation, the 10% tax is increased to 25%. Further—

- A participant who withdraws funds from a SIMPLE IRA may continue to participate in the employer's SIMPLE IRA plan.
- SIMPLE IRA contributions and earnings must eventually be distributed following the IRA required minimum distribution rules.
- SIMPLE IRA contributions and earnings may be rolled over PDF tax-free from one SIMPLE IRA to another. A tax-free rollover may also be made from a SIMPLE IRA to an IRA that is not a SIMPLE IRA, but only after 2 years of participation in the SIMPLE IRA plan.

Participant loans are not permitted.

Eligible Employees

An *eligible employee* (including a self-employed individual) is one who—

1. earned at least $5,000 in compensation during any two years before the current calendar year and
2. expects to receive at least $5,000 during the current calendar year.

An employer can use less restrictive participation requirements, but not more restrictive ones. For example, an employer can eliminate or reduce the prior or current year compensation amounts. Employers cannot impose any other conditions for participating in a SIMPLE IRA plan.

Employee Contributions

SIMPLE IRAs hold the contributions made for each eligible employee. For 2020 and for 2021, annual employee salary reduction contributions (elective deferrals limited to $13,500). For employees age 50 or over, a $3,000 "catch-up" contribution is also allowed.

Employer Contributions

An employer is required to contribute each year either a—

1. Matching contribution up to 3% of compensation (not limited by the annual compensation limit), or
2. 2% nonelective contribution for each eligible employee

Under the "nonelective" contribution formula, even if an eligible employee doesn't contribute to his or her SIMPLE IRA, that employee must still receive an employer contribution to his or her SIMPLE IRA equal to 2% of his or her compensation up to the annual limit of $290,000 for 2021; $285,000 for 2020 (subject to cost-of-living adjustments in later year.

When Must Contributions Be Deposited?

1. Employee salary reduction contributions. As soon as possible but no later than 30 days after the end of the month in which the amounts would otherwise have been payable to the employee (including self-employed individuals) in cash.
2. Employer matching or nonelective contributions. By the due date (including extensions) for filing your federal income tax return for the year.

Special Rules for Self-employed Persons

Self-employed persons must be eligible to participate in the SIMPLE IRA plan the same as any other employee. However, the following special rules apply to such persons:

1. Special rules apply for determining compensation. For a self-employed individual, *compensation* means net earnings from self-employment, as defined in IRC Sec. 1402(a), without regard to the self-employed person's SIMPLE plan contribution [IRC Sec. 408(p)(6)(A)]. Essentially, it is self-employed income (Sch C /F) reduced by 7.65% (One half of the Social Security and Medicare)
2. Income is deemed to be earned as of the last day of the year [Reg. 1.401(k)-1(a)(6)(iii)]. This means that elective deferrals on behalf of the self-employed person need not be deposited until after the last day of the year. It also means that a self-employed person's total net earnings for the year are used in determining the maximum contribution allowed, even if the deferral election is made after the first day of the year (but no later than the last day of the year).
3. Matching contributions can be made for self-employed persons in the same manner and under the same rules applicable to any other employee [IRC Sec. 408(p)(9)].

When and How Contributions Are Deductible

Contributions to a SIMPLE IRA plan are deductible in the employer's tax year with or within which the calendar year for which the contributions were made ends [IRC Sec. 404(m)(2)]. However, for employer matching (or nonelective) contributions, a deduction is allowed for a year only if the contributions are made by the due date (including extensions) for the employer's tax return.

SIMPLE IRA contributions made on behalf of employees are deducted on Schedule C (or F). Payments made on behalf of the self-employed business owner are deducted on Schedule 1 of Form 1040 as an adjustment to gross income.

EXAMPLE: Sam Chooses a SIMPLE Plan

As in the previous SEP example, Sam's Schedule C income is $40,000. Sam decides on using the SIMPLE Plan. Since her business was started in January, she sets the plan up by October 1 of that year. She uses either Form 5304 or Form 5305 to establish the plan. Since she is the only participant, she maintains a copy of the plan document. The plan has a 3% match.

Under the special self-employed rule, she is deemed to have earned her earned income as of the last day of the year (December 31). Being under age 50, Sam can contribute up to $13,500. This portion should be deposited on later than 30 days from the end of the year.

In addition, Sam is entitled to a 3% match based on her net self-employment income of $1,108. The total maximum contribution under this plan is $14,608 which is substantially higher than the maximum SEP contribution of the previous example of $7,435.

	Match
Net Schedule C Income	$ 40,000
Less (7.65%)	(3,060)
SE Earnings for Plan contributions	$ 36,940
3% Match	$ 1,108

Variation: As in the SEP Example's variation, Sam hirers Debbie of December of Year 1. Does she have to cover Debbie in the initial year? No, Debbie would have to have been paid at least $5,000 in the prior two years and an expectation of making at least $5,000 in the current year to qualify for the plan. Assume that Debbie only made $1,000 in year 1 but makes at least $5,000 in the Year 2 and Year 3. She will be eligible at the beginning of Year 4 for the plan.

One-Participant 401(k) Plans

A one-participant 401(k) plan is sometimes called a Solo 401(k), Solo-k, Uni-k or One-participant k. It is a traditional 401(k) plan covering a business owner with no employees, or the owner and their spouse. These plans have the same rules and requirements as any other 401(k) plan.

Contribution Limits in a One-Participant 401(k) Plan

The business owner wears two hats in a 401(k) plan: employee and employer. Contributions can be made to the plan in both capacities. The owner can contribute both:

1. Elective deferrals up to 100% of compensation ("earned income" in the case of a self-employed individual) up to the annual contribution limit $19,500 in 2020 and 2021, or $26,000 in 2020 and 2021 if age 50 or over.

2. Employer nonelective contributions up to 25% of compensation as defined by the plan, or for self-employed individuals.

Total contributions to a participant's account, not counting catch-up contributions for those age 50 and over, cannot exceed $57,000 (for 2020; $58,000 for 2021).

A business owner who is also employed by a second company and participating in its 401(k) plan should bear in mind that his limits on elective deferrals are by person, not by plan. He must consider the limit for all elective deferrals he makes during a year.

Adopting and Funding a Qualified Retirement Plan

A qualified retirement plan must legally exist by the taxpayer's year-end to claim a deduction for the contribution. Thus, calendar-year taxpayers must adopt the plan by December 31. In addition, the trust agreement (if the plan uses a trust) and the plan itself must be in writing and communicated to employees by that date [Reg. 1.1401-1(a)(2)]. Some states require that the trust be funded with at least a nominal amount of money prior to year-end.

LAW CHANGE ALERT: If an employer adopts a qualified retirement plan before the due date, including extensions, of the tax return for the tax year, the employer may elect to treat the plan as having been adopted as of the last day of the tax year [SECURE Act § 201].

Due Date of Plan Contributions

Contributions to qualified retirement plans are generally deductible only in the year paid. However, a special rule permits a deduction for certain contributions made after year-end. Under this rule, a contribution is treated as made on the last day of the tax year if (a) it is identified as being made for that year, and (b) it is actually made by the due date of the taxpayer's return, including extensions [IRC Sec. 404(a)(6)]. If the retirement plan contribution is made by mail, the postmark date is the controlling date.

Example: Establishing tax year in which profit-sharing contribution is deductible.

Sam is eligible to contribute $19,500 to her profit-sharing plan. On February 22, 2022, she pays $19,500 to the retirement plan trust and identifies the contribution as being for 2021. Since the contribution was made before the due date of her personal tax return and is identified as a 2021 contribution, it is deemed made on the last day of 2021 and thus deductible on her 2021 return.

Net Earnings from Self-Employment

For SEP and qualified plans, net earnings from self-employment are your gross income from your trade or business (provided your personal services are a material income-producing factor) minus allowable business deductions. Allowable deductions include contributions to SEP and qualified plans for common-law employees and the deduction allowed for the deductible part of your self-employment tax.

For the deduction limits, earned income is net earnings for personal services rendered to the business. The income tax deduction for the deductible part of self-employment tax and the deduction for contributions to the plan made on the owner's behalf are reductions when figuring net earnings.

Net earnings include a partner's distributive share of partnership income or loss (other than separately stated items, such as capital gains and losses). Guaranteed payments to limited partners are net earnings from self-employment if they are paid for services to or for the partnership. Distributions of other income or loss to limited partners *are not* net earnings from self-employment.

Testing in a One-Participant 401(k) plan

A business owner with no common-law employees doesn't need to perform nondiscrimination testing for the plan, since there are no employees who could have received disparate benefits. The no-testing advantage vanishes if the employer hires employees. No matter what the 401(k) plan is called by a plan provider, it must meet the rules of the Internal Revenue Code.

If the employer hires employees *and* they meet the plan eligibility requirements, they must be included in the plan, and their elective deferrals will then be subject to nondiscrimination testing [unless the 401(k) plan is a safe harbor plan or other plan exempt from testing]. It is permissible to exclude from coverage any employee who is either under age 21 or has worked fewer than 1,000 hours during any 12-month period [IRC Sec. 410(a)(1)(A) and (3)(A)]. Thus, young and part-time employees (including the owner's spouse and children, if applicable) need not cause complications for what is intended to be a 401(k) covering only the owner.

A one-participant 401(k) plan is generally required to file an annual report on Form 5500-EZ if it has $250,000 or more in assets at the end of the year. A one-participant plan with fewer assets may be exempt from the annual filing requirement.

Loans Are Allowed

The one-person business owner can borrow from his or her 401(k) account if the plan document allows. The maximum loan amount is the lesser of 50% of the account balance or $50,000. Additional loan amounts were allowable under COVID and disaster relief.

Sponsors of 401(k) plans have the option to include designated Roth accounts (DRAs) as part of the plan. DRA contributions are elective contributions that are [Reg. 1.401(k)-1(f)(1)]:

- irrevocably designated by the employee at the time of the deferral election as Roth contributions.
- treated by the employer as wages and included in the employee's income at the time of deferral; and
- maintained by the plan in a separate account.

To take advantage of DRAs, they must be provided for in the plan document.

EXAMPLE: Sam selects a solo 401(K) plan

Sam decides that she like the long run advantages of the 401(k) is okay with the additional costs. Being under age 50, Sam will be able to defer $19,500 of her earnings plus have a profit-sharing component of 20% of her net employment income ($40,000 less $2,826 or $37,174) for $7,435. For a total contribution of $ 26,935.

It is highly unlikely that a young individual without other resources could want or afford a contribution of such a large percentage of her income. However, even if she did not fully maximize her contribution, she still has the ability to make designated Roth contributions and borrow from the plan.

NOTE: The calculation for the previous calculation can be as many as 21 steps. A worksheet and tables for this calculation can be found in Pub. 560- Retirement Plans for Small Business.

WHERE TO GO FOR MORE INFORMATION:

- Checkpoint's Tax and Financial Planning Library—
  - *PPC's Guide to Self-Employed Individuals*
  - *PPC's Guide to Tax Planning for High Income Individuals*
  - *PPC's Guide to Small Business Retirement Plans*
  - *PPC's Guide to Retirement Planning*
- Checkpoint's Tax Compliance Library—
  - *PPC's 5500 Deskbook*
- IRS Publication 560, *Retirement Plans for Small Business*

CHAPTER 32: BUSINESS USE OF THE HOME

Learning Objectives

Completion of this chapter will enable participants to—

- Determine if a taxpayer is entitled to a deduction for a home office.
- Calculate the home office deduction using the allocation method and apply limitations.
- Calculate the home office deduction using the safe harbor method.
- Identify the best home office deduction method to use in different situations.

IMPORTANT TO NOTE

In recent years, there has been much discussion regarding the remote workplace. Obviously, the onslaught of the COVID-19 pandemic has increased the amount of people working from home. In a 2021 survey conducted by Topia, 28% of employees surveyed said they had worked outside their home state or country since the start of COVID-19.

A home office deduction is no longer allowable for employees, because the TCJA repealed miscellaneous itemized deductions subject to the 2%-AGI floor.

NOTE: A reservist, fee-based government official or performing artist who meets all other requirements for a home office would be allowed a deduction that would be reported on a Form 2106. Currently, Form 2106 may only be used in limited situations. It exclusively now flows to Line 11 of Form 1040 (Schedule 1), as an adjustment to income. See Chapter 41 for more information.

However, a sole proprietor or a partner in a partnership may still take a home office deduction after enactment of the TCJA.

OBSERVATION: As more workers are working from home, employers should consider instituting accountable plans to pay for the costs associated with telecommuting.

1. Employers may reimburse the direct and indirect expenses of a telecommuting employee maintaining an office in the home, including utilities, insurance, property taxes, depreciation, etc.
2. Employers may also reimburse an assortment of home office supplies and equipment costs (e.g., office equipment, computer, printer, and high-speed internet connection) for the telecommuting employee’s use.
3. An issue for employers is how to treat reimbursements of these home office expenses. Until the IRS directly addresses the issue, employers must look to the general principles found in the accountable plan rules for guidance.
4. These plans have an advantage for both employer and employee. The reimbursements are deductible to the employer while the reimbursements are not taxable to the employee.

5. Although not explicitly required by the Code or regulations, employers should adopt a clear and concise, written accountable plan document or policy statement. It should specify what expenses will be reimbursed, detail the reporting and substantiation required, and explain the time limits within which excess advances must be substantiated or returned. It should also specifically designate arrangements, employees, or types of payments to specific employees that are exempt from coverage under the accountable plan.

GENERAL DISALLOWANCE

IRC Sec. 280A(a) generally disallows a trade or business deduction for use of a taxpayer's residence. However, IRC Sec. 280A(c) provides exceptions for certain business or rental use subject to limitations.

The disallowance does not apply to any portion of a residence used exclusively and on a regular basis [IRC Sec. 280A(c)(1)]:

1. As a taxpayer's principal place of business for any trade or business,
2. As a place of business used by patients, clients, or customers in the normal course of the trade or business, or
3. A space used in connection with a trade or business, if a separate structure not attached to the residence.

EXAMPLE: Determining if home office use qualifies for deduction

Cindy, a self-employed attorney, works three days per week in an office downtown. Two days each week she meets with clients in her home office. The home office qualifies for a business deduction because she meets clients there in the normal course of her business.

Note: This exception applies only if the use of the dwelling unit by patients, clients, or customers is substantial and integral to the conduct of the taxpayer's business. Occasional meetings are insufficient [Prop. Reg. 1.280A-2(c)].

The same home office can be a principal place of business for two or more separate business activities. Whether the disallowance exception under IRC Sec. 280A(c)(1) applies is determined separately for each of a taxpayer's trades, businesses or professions.

Prop. Reg. 1.280A-2(g)'s exclusive use requirement means a taxpayer must use a specific portion (e.g., room or part of a room) of a home for business purposes only; there is to be no other personal use of the space at any time during the taxable year.

COURT CASES: In *McMillan*, a self-employed taxpayer and experienced equestrian, who worked from home doing information technology work and also allegedly conducted not-for-profit horse breeding and showing activity, wasn't entitled to a home office deduction under IRC Sec. 280A for the portion of insurance, utilities, depreciation, and other expenses allegedly related to her home office, which she claimed took up her entire living room (or 50% of her one-bedroom apartment). Notably, even though her claim of using her living room as the principal place of business for her information technology work was credible, IRC Sec. 280A's exclusive use requirement wasn't met because taxpayer (by her own testimony) showed that she also used living room for other things such as non-business horse activity and such other activities as website management and working on multiple lawsuits in which she was engaged (*McMillan v. Comm.*, TC Memo 2019-108).

In a similar outcome, the taxpayer in *Savulionis*, a vascular ultrasound technologist, opened a sole proprietor business treating patients at a clinic. His spouse was employed as his bookkeeper and he claimed home office expenses for the living room where she did her work. The taxpayers and their daughter lived in a 1,000-square-foot house. To enter and leave the house, one must pass through a 340-square-foot living room. The taxpayer used the living room for some business-related purposes yet claimed the entire living room was used exclusively for business purposes.

This living room being used exclusively for business purposes was inconsistent with any commonsense notion of the everyday realities of family life for a three-person family in a dwelling unit as described by the taxpayers. The taxpayers were not entitled to deductions for expenses attributable to the living room, because it was not used exclusively for business (*Savulionis v. Comm.*, TC Summary Opinion 2015-19).

Miller reached a different result. A taxpayer was entitled to claim a home office deduction for part of her New York City single-room studio apartment. She testified credibly that she frequently met with company clients, performed work using a computer on a desk, and stored books, magazine, supplies, and samples related to the company's work. Although she admitted to using portions of the "office space" for nonbusiness purposes, the court determined such use was de minimis and unavoidable due to the small size of her apartment. The court allowed a deduction for one-third of the rent and cleaning expenses, the VoIP telephone line, and 70% of the cost of internet service (*Miller v. Comm.*, TC Summary Opinion 2014-74).

There are two exceptions to the exclusive use rule:

1. The first is for certain storage use [IRC Sec. 280A(c)(2)]. The exception applies to the portion of a home used for storage of inventory or product samples provided the following tests are met:

    a. The storage space in the home is used on a regular basis for storage.

    b. Taxpayer is in the trade or business of selling the stored products.

    c. The taxpayer's home is the only fixed location for the trade or business.

2. The second exception is for a portion of a home used to provide day care services [IRC Sec. 280A(c)(4)]:

    a. Taxpayer must be in the trade or business of providing daycare for children, persons age 65 or older, or persons who are physically or mentally unable to care for themselves.

    b. Taxpayer must have applied for, been granted, or be exempt from having a license, certification, registration, or approval as a daycare center or a family or group home day care under state law.

For direct expenses, day care providers determine business percentage by calculating hours used on a regular basis as a percentage of total hours in a year (8,784 hours for 2020).

For indirect expenses, day care providers determine business percentage by calculating percentage of square feet used multiplied by percentage of time used for day care.

PLANNING TIP: When a residence qualifies for a home office deduction, a taxpayer may deduct all daily transportation costs incurred in going between the residence and other locations in the same trade or business (Rev. Rul. 99-7). This applies regardless of whether the other work location is regular or temporary and regardless of distance.

SIMPLIFIED HOME OFFICE DEDUCTION

A taxpayer may use a simplified method of calculating a home office deduction. This safe harbor method is an alternative to substantiation, allocation, and calculation of actual expenses to satisfy IRC Sec. 280A [Rev. Proc. 2013-13].

The deduction is equal to the square footage (300 sq. ft. maximum) used for qualified business purposes multiplied by a prescribed rate of $5. Therefore, the maximum amount a taxpayer can currently deduct annually without substantiation under the safe harbor is $1,500. The IRS and Treasury Department may update the rate as warranted, but it is not inflation adjusted.

1. To determine allowable square footage, a taxpayer must determine an average of monthly allowable square footages for a taxable year.

2. In determining an average monthly allowable square footage, no more than 300 square feet may be used for any one month and a taxpayer is treated as having qualified business use in any month with 15 or more days of qualified business use.

EXAMPLE: Using the simplified home office deduction

Melody begins using 400 square feet of her home for qualified business use on July 20 and continues until the end of the year. She has an average allowable square footage of 125 square feet [300 square feet for each month August through December, divided by the number of months in the taxable year [(300 × 5) ÷ 12 = 125]. Her safe harbor deduction is $625 (125 × $5).

3. Taxpayers sharing a home may each use the safe harbor method, but not for the same portion of a home.

4. A taxpayer who has more than one qualified business use in the same home and who elects the safe harbor method must use the safe harbor method for each qualified business use and is limited to a maximum of 300 square feet. If a taxpayer uses more than 300 square feet, they must allocate the square footage among their qualified businesses in any reasonable manner but may not allocate more square footage than is used in the business.

5. A taxpayer with qualified business use of more than one home for a taxable year may use the safe harbor method for only one home during that taxable year. However, if otherwise eligible, a taxpayer may calculate and substantiate actual expenses for business use of any other home for a taxable year.

A taxpayer electing to use the safe harbor method cannot deduct any actual expenses related to qualified business use of the home for that tax year.

Election to use the safe harbor method is made on an annual basis. A change from using the safe harbor method in one year to actual expenses in a succeeding year, or vice-versa, is not a change in method of accounting and does not require consent of the Commissioner.

The election is made by choosing to compute the deduction using the safe harbor method on a timely filed, original federal income tax return for a taxable year. Once made, an election is irrevocable.

A taxpayer who itemizes deductions and uses the safe harbor method may deduct, to the extent allowed under the IRC and regulations, any expense related to a home that is deductible without regard to whether there is qualified business use of the home (e.g., qualified residence interest, property taxes, and casualty losses).

PLANNING TIP: When calculating which method gives a taxpayer a larger deduction, a preparer should take great care. What may look like a larger deduction using the actual method may not be so, because the full deduction for qualified residence interest, property taxes, and casualty losses is allowed as an itemized deduction when using the safe harbor method. However, with the increased standard deduction under the TCJA, fewer taxpayers will itemize their deductions, so reevaluating is in order.

A taxpayer using the safe harbor method cannot deduct any home office-related depreciation or Section 179 expense, and allowable depreciation is deemed to be zero.

PLANNING TIP: This fact makes a safe harbor election even more attractive because it avoids depreciation recapture on sale of a residence. (Chapter 14 discusses reporting a sale of a residence, including one with a home office.)

The amount of a safe harbor deduction cannot exceed the gross income derived from qualified business use of a home for a taxable year reduced by other business deductions:

1. Any amount more than the income limitation is disallowed and may not be carried over and claimed as a deduction in a later year.

2. A taxpayer cannot use a carryover from an actual expense method year but can save it and use it the next time they use the actual expense method.

PLANNING TIP: The reduced complexity of the safe harbor method makes it more attractive for many taxpayers to claim a home office deduction as it masks the “red flag” illusion and eliminates depreciation recapture. However, the deduction is limited to $1,500, so a savvy preparer should calculate it both ways and consider using the actual method where it provides a significantly higher deduction. For example, a deduction for a 12 ft. × 12 ft. office using the safe harbor method is only $720; the maximum $1,500 deduction would require a space of approximately 17.5 ft. × 17.5 ft.

COMPUTING THE HOME OFFICE DEDUCTION BY ALLOCATION

Divide the area used for business by the total area in the home to determine the pro rata share of rent, utilities, etc.

CAUTION: Clients generally know the square footage of their home but may give you a ridiculously high estimate of the square footage of their office. You can avoid problems during a later audit by asking them for the office's length and width.

Depreciation is based upon the lower of a home's adjusted basis or FMV at the time placed in service and must use MACRS 39-year straight-line depreciation.

All expenses pertaining to a residence must be allocated between business-use and personal-use and divided into three categories [Prop. Reg. 1.280A-2(i)(5)]:

1. Unrelated expenses that benefit only the personal portion of a residence, such as expenses to paint a master bedroom, and are not deductible at all.

2. Direct expenses that benefit only the business portion of a taxpayer's home, such as expenses to paint an area used exclusively as an office and are allocated 100% to home office expenses.

COURT CASE: In *Kilpatrick*, the taxpayer (a licensed Georgia CPA) was denied business deductions for costs of his office furnishings, including armchairs, desks, clocks, a chandelier, and other items. The Court concluded these amounts were paid to acquire personal tangible property and were not ordinary expenses under IRC Sec. 162. In addition, several of the items were antiques that would retain their value, rendering no depreciation deductions. The IRS was particularly interested in a $4,428 painting where the taxpayer deducted half as "office expense" and half as "supplies expense." (*Kilpatrick v. Comm.*, TC Memo 2016-166)

Indirect expenses benefit both the business and personal use portions of a taxpayer's residence and are deductible on a pro rata basis, subject to income limitation. Examples of indirect expenses include rent, mortgage interest, real estate taxes, utilities, insurance, repairs, cleaning, casualty losses, and depreciation.

NOTE: Mortgage interest and casualty losses must be otherwise deductible to be considered an indirect expense.

A deduction for business use of a home (other than from otherwise deductible expenses, such as mortgage interest and real estate taxes) is limited to net income from the business. Deductions cannot create or increase a loss from a business. To determine the limitation, a business use of home deduction is claimed in the following order:

1. Business percentage of expenses allowable as deductions in any case (e.g., qualified mortgage interest and real estate taxes). These expenses are fully deductible even if they exceed net income from the business.

2. Other expenses for business use of a home (e.g., repairs and maintenance, utilities, and insurance).

3. Depreciation of the home office space.

Excess expenses resulting from categories 2 and 3 can be carried forward to future years indefinitely and retain their character as home office deductions. The net income limitation applies in succeeding years whether or not the home continues to be used as a residence.

COURT CASE: In *Cartwright*, an on-call physician worked 24-hour shifts three days a month at a hospital 25 miles from his home. He would drive to the hospital in a motor home he used for rest and sleep. Over a two-year period, he deducted 85% and 100% of expenses related to his motor home, because he claimed he used it as a mobile office. On audit, the IRS limited the deduction for motor home expenses to 19.42% and 22.23% for the two years, based on the ratio of business miles to total miles driven in each year. The Tax Court found the IRS calculation to be correct. Therefore, the expenses were allocated between business and personal use based on total mileage and not the time it was used as a "mobile office." (*Cartwright v. Comm.*, TC Memo 2015-212)

INTERPLAY BETWEEN SALT AND HOME EXPENSE DEDUCTIONS

Expenses for the business use of a home under IRC Sec. 280A(b) are deductible if they would have otherwise been allowable as individual expenses. If an individual's total state and local taxes meet or exceed the $10,000-limit ($5,000-limit for MFS) imposed by the TCJA, or the standard deduction is claimed, none of the taxes relating to the business use of the home qualify for the IRC Sec. 280A(b) exception. If an individual's total state and local taxes do not meet or exceed the limit imposed by the TCJA, the individual can expense the business portion of the taxes up to the difference between the $10,000 ($5,000) limit and the amount actually deducted under IRC Sec. 164 [PMTA 2019-001].

EXAMPLE: Determining allocable portion of SALT to home office deduction

Joe opens a new business as a sole proprietorship and has a loss in the initial year. Joe's office-in-home, his total basement, is 33.3% of the square footage of the home. Joe's real estate taxes on the home are $12,000. He also pays $5,000 in state and local income taxes. The real estate taxes are allocated $8,000 to the individual use of the home and $4,000 to the office use of the home. Joe's total individual state and local taxes paid equal $13,000 (i.e., $8,000 individual real estate taxes plus $5,000 state and local income taxes). Under IRC Sec.164(b)(6), Joe's individual itemized deduction for state and local taxes is limited to $10,000. Because Joe's actual individual state and local taxes exceeds the $10,000 limit under IRC Sec. 164(b)(6), his $4,000 of real estate taxes attributable to the office are subject to the gross income limitation under IRC Sec. 280A(c)(5). None of Joe's real estate taxes attributable to the office use of his home are expenses under IRC Sec. 280A(b).

However, excess real estate taxes may still be deductible as other expenses for business use of a home (e.g., repairs and maintenance, utilities, and insurance), subject to the net income limitation of IRC Sec. 280A(c)(5).

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers)*
- IRS Pub. 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*
- Rev. Proc. 2013-13
- Form 1040, Schedule C, instructions
- Form 8829, Expenses for Business Use of Your Home, instructions

CHAPTER 33: THE POST-PANDEMIC OFFICE

Learning Objectives

Completion of this chapter will enable participants to—

- Recognize the issues associated with working away from the traditional office.
- Determine the additional security risks associated with remote work.
- Identify the issues affecting cloud computing implementation.

THE CHALLENGES OF WORKING REMOTELY

Networking

The business model of office-based work may have changed forever. The home office is more frequently the focus of work, often working in more isolation. The question that needs to be asked is, what does it require for an accountant to successfully work without being "in the office"? Things to consider:

- Do I need to reconsider how I work with the client and/or workers?
- What about networking? There certainly is a difference between building a relationship online versus in-person meetings. Networking is the same game just in a new package. Let's talk a little about these important networking steps (**www.indeed.com/career-advice/finding-a-job/become-a-networking-expert-in-7-steps**).

    1. <u>Talking to new people at networking events.</u> Take advantage of the opportunities to meet new people. When you attend an event, work on creating a connection based on our own goals and comfort level. Online you have approximately three seconds to make a connection, a very difficult challenge.

    2. <u>Attend new events.</u> Extend your sphere. This will take you out of your comfort level but will present an opportunity to enhance who you are. Look online for events that are geared toward your interests or perhaps your arena of expertise.

    3. <u>Create authentic relationships.</u> Often, the fast-paced world in which we live, it is difficult to be authentic. One of the examples that comes to mind is speed dating: a person is charged with the task of establishing a connection with a person over a limited period of time to determine if they might have an interest in a relationship with that person. When finding a person that may be of interest, try to find common interests and goals that has the possibility of extending the conversation. Directing the conversation to be about that person is always more successful than talking about yourself.

    4. <u>Be confident.</u> A person who is self-aware and confident in a person to person gathering always attracts attention. The lack of self-confidence in a virtual event is multiplied by a factor of 10. When preparing for a networking event, rehearse responses to common questions you might encounter when you speak to new people, such as, "Tell me about yourself," or "How long have you been in the industry?" Having an answer ready will ensure your delivery is smooth. It is easy to check a person off the list who stumbles and mumbles at something as basic as "Tell us about yourself."

5. <u>Stay connected.</u> Do not let those new contacts go stale. Make an offer to meet with them at a specific time to continue your conversation about a shared interest. Try to reconnect with them every few months by emailing an interesting article or industry-related news.

6. <u>Revisit older connections.</u> We all have people with whom we have lost connections. Without a little maintenance those people become history versus relationships. Maintaining connections is an important part of networking since you may be able to provide each other with valuable industry information. To keep an open line of communication, contact those in your network you haven't spoken to in a few months. You can ask for updates on their career or if they'd like to meet in person to reconnect.

7. <u>Find new connections online.</u> All of these comments can be applied to physical or virtual networking, but the best way to learn how to network in the virtual world is to seek out connections that are totally virtual. It can also be useful to try to connect to experts in your field. If the expert posts content regularly, you may learn valuable information that you can apply to your work. If you want to make a more personal connection, try sending them a private message with a question that relates to your industry or a comment about how you admire their work.

IS IT MORE EFFICIENT TO WORK FROM HOME?

Like with so many things, the answer is subjective. An enrolled agent, Brian Hershman, writes that as someone who worked from home back in 2007, his opinion, working remotely is more efficient than working in the office (**www.cpapracticeadvisor.com/firm-management/article/21230254/is-it-more-efficient-to-work-from-home**), stating, "Small talk, long lunches, and distractions are the reason for inefficiency."

Some of Mr. Hershman's more salient points:

- "I think remote is the way to stay if you are a small firm with a few employees."
- "Consider a hybrid model combining the best of both worlds."
- "Structure your firm with efficiencies that focus on a championship culture. Great teamwork helps boost efficiency, so a culture developed in person can pay long-term dividends."
- "The best person I know who taught culture was a basketball coach, who believed a great culture occurred when the following happened: Every single manager and coach had an emergency and needed to leave—and the team and practice level had no drop-in activity. They could run it themselves and keep the same level of integrity."

NINE WAYS TO MAKE REMOTE WORKING SUCCESSFUL

After looking at the challenges associated with remote working, the *Journal of Accountancy* took on the question of how to succeed while working remotely. In January 2021, two accounting entrepreneurs (Chad Davis CPA and Josh Sweig, CPA) were asked how to best succeed in operating a remote practice, as they had formed an all-virtual firm 13 years prior while experiencing tremendous growth. They now have 80 employees with ZERO brick and mortar presence.

1. <u>Take Up Technology.</u> Embrace technology and learn how to effectively use it. Additionally, seek out quality solutions. One of the additional commentators, Rohit Bhargava, a virtual entrepreneur,

watched several You Tube presentations of setting up a virtual studio. Chad Davis CPA noted that in the virtual world the perception of you will be a rectangular box. An additional challenge you will be given only three seconds, on the average, before you are judged by those who are watching/listening to you in the rectangle. Invest in the best equipment you can, nothing is more difficult than a lagging internet, grainy image, or poor sound quality. If you are sensitive to what you look like on camera, you need to consider that those who hide behind a still image can be perceived unengaged or not approachable.

2. <u>Refine Your Routine.</u> Plan your day, resist the temptation to spend the day reading email or other communications. The suggestion from Mr. Bhargava, "When you wake up, center yourself, do deep breathing, and think about what your priorities for the day are going to be."

3. <u>Be Candid.</u> There will be instances of interruptions and noise from your surroundings, admit what has happened and move on. Spell out your weaknesses to customers or others, which can naturally build trust. That realism and truth helps to speed up the relationship-building portion of an online relationship.

4. <u>Be Flexible and Cognizant of Communication Styles.</u> To build rapport adapt your communication style to whom you are working. In digital communications errors can occur, Attempt to correct those mistakes in person. Davis's firm has dealt with "communication sensitivity" for years, and this issue is a continual work in progress. "Sometimes communication issues can be avoided with more effective incentive structures and procedures that tend to be the source of communication breakdowns," he said. "So, we've taken a more 'root-cause' approach to communication over the years."

5. <u>Be Punctual.</u> In the virtual world meetings start on time and end on time, period. This means that you also must learn to be a more functional communicator. When working remotely, it is important to be more respectful of other people's time.

6. <u>Sparkle.</u> Three seconds is not a lot of time, smile from beginning and make it count. It conveys warn, friendly, open, and approachable. Make eye contact and look at the camera not your computer screen.

7. <u>Introduce Yourself Effectively.</u> One of the effective techniques for introducing yourself on a virtual presentation or even a call, deliver your name as follows, my name is XXXX, pause, XXXX YYYY. Be specific about what you do, i.e., not "I am a tax accountant", rather "I am a CPA/EA working with small business taxpayers as their virtual CFO."

8. <u>Do What You Can to Recognize the Commonalities of Yourself versus Others.</u> When making a virtual presentation, attempt to draw a parallel of the weather between your location and the moderator's locations. This helps make the person more real and in touch with the others who are watching, listening, or participating in the presentation/conference.

9. <u>Ask Questions and Follow-up.</u> When speaking with others online avoid being invisible, do what you can to stand out, i.e., "Joe that was an excellent point." Be Yourself – From the time as a child one of the first things we are taught is to act certain ways in certain situations. Ignore that. Be yourself and act like who you are. Chad Davis says, "The things that make you unique will attract the right customers to you," he said, adding, "embrace your home schooling kids who barge into your call, pet the dog that wants attention, and don't be afraid to sneak a quick snack. The pandemic has had a life-altering effect on everyone, and we're all human at the end of day."

EQUIPMENT FOR WORKING FROM HOME

OBSERVATION: Included are examples of available technology; these are merely meant to be demonstrative. There is no single absolute best system. We all have different needs and preferences, so choose software and equipment that is right for your situation. Purchase wisely and deal with vendors which offer strong return policies, like Amazon, New Egg, etc. One of our authors returned several notebook docking stations purchased from Amazon before finding a suitable alternative. The company credited his account on the date the packages were delivered to the service center without question.

Knowing what we know now tells us that we should not be surprised and/or be unprepared when that time to work remotely from home arrives. Many people love working from home, others not so much. Some of those feelings are a result of a poorly considered working space at home. Treat a space like you do at the office. If possible, dedicate an area solely to your working remote activity. Consider some thoughts of setting up that space, **www.flexjobs.com/blog/post/setting-up-home-office-v2**.

The home laptop is going to be strained if called upon to be the production computer. If unable to invest in a new desktop, which requires more desk space and floor space (it is in your best interest to find the space), the laptop docking station can be a helpful solution.

With one connection, you can have power and all the necessary peripherals to successfully conduct your business without going to the office. If it is necessary to take your laptop to a meeting, it is easily unplugged and go with you.. Many offices are considering using the following configuration in the office and at home with the user transporting the laptop from location to location:

1. Multiple monitors
2. Additional USB ports
3. Gigabit ethernet jack (a wired connection is a must for the home worker)

The choices available are great and varied. Costs range from as little as $115 to as much as $750. PCMag.com does a great review each year of the best docking stations for laptops. The 2020 review can be found at **www.PCMag.com** and searching “best docking stations for windows laptops.”

EXAMPLE: Author's Setup

The image shown here is the author's studio. Everything plugs into a laptop docking station designed for the Windows Surface Laptop (this is not the computer I use for production at home). If I need the laptop for a seminar, conference, or client meeting, I unplug one connection from the docking station. Placing the machine in my bag is easy without having to unplug cables and connections from the laptop.

Moving from Top to Bottom:

1. 42" TV Monitor – Most TV monitors produced in the last decade have an HDMI port that can be used as a video monitor for a computer.

2. Logitech Webcam

3. Surface Laptop

4. Docking station (lower right)

5. Bluetooth Microphone (lower left)

All the peripherals are controlled by the MS Surface, except the TV is powered on, and input selected, with the remote. Images are either duplicated across both monitors and extended like our office.

There are other pieces of equipment that should be considered to attach to your laptop/docking station. Like in the office, good ergonomics is also important at home:

1. Mouse. The laptop touchpad is often inadequate/cumbersome. There are numerous USB/Bluetooth mice available. (search "best wireless mice" at **www.pcmag.com/picks/the-best-computer-mice**).

2. Keyboard. Often available with a mouse. These wireless devices can be plugged into an available USB port (search "keyboards with mouse" at **www.newegg.com/Keyboards/SubCategory/ID-63?cm_sp=Cat_Keyboard-Mice_2-_-VisNav-_-Keyboards**).

3. Headphones. Do not skimp on quality here. Gaming headphones are generally the highest quality but for may be a bigger investment than necessary. Bluetooth or wireless earbuds are less expensive and deliver quality sound (search "best headphones in 2021" at **www.tomsguide.com/us/best-headphones,review-1988.html**). An advantage of gaming headphones is the incorporation of padded speakers and a boom mic. A solid pair of earbuds can be purchased for as little as $20, and a good pair of headphones can be bought for about $85.

4. Webcam. The gold standard in the eyes of most is the Logitech C922 webcam. One of the highly rated Logitech cameras is the Brio, however they continue to have a firmware issue with Microsoft Surface. A good comprehensive listing can be found at **www.techradar.com/news/computing-**

components/peripherals/what-webcam-5-reviewed-and-rated-1027972 and searching "best webcams for working from home."

5. External storage. Cloud storage is flexible and scalable. Find a cloud provider that works for your situation to put the information at your fingertips without the risk of the portable hard drive being stolen, **www.cloudwards.net/best-cloud-storage**. While free services can be alluring beware…often free services come without important security tools.

6. Second monitor. Monitors that were almost impossible to find during the pandemic are now more available. However, the best quality equipment continues to be in limited supply. As noted earlier, a TV can be used as a second monitor if none are available, or it is currently not in the budget. Do not give in to the urge to save money here, your eyes will thank you years from now. Look for 4K resolutions (3840 × 2160 pixels) A competitive list can be found at **www.pcmag.com/picks/the-best-computer-monitors**.

7. USB hub. Many of these peripherals use a USB port. Laptops seldom have more than two or three USB ports. The author prefers the use of a docking station which will add additional USB ports. If that will not work, consider a powered USB Hub **www.pcmag.com/picks/the-best-usb-and-usb-c-hubs**.

8. Surge protector. This is a must—not a could or a should. Like the USB hub, it is not expensive ($30–$50). Power is subject to spikes and surges and all this neat equipment must be protected with clean power.

9. Comfortable chair. Your posture and your back could use one of those costly ergonomic chairs (a family member spent over $1,000 on one after being assigned to work from home) but difficult to do during the times of a stressed budget. There are many people who now have close personal relationships with chiropractors and physical therapists due to poor choices of seating. These chairs do not need to break the budget (**https://nymag.com/strategist/article/best-ergonomic-office-chairs.html**). Many different seat cushions are also available that can help with the seating decision at a reasonable price ($30–$50) to save your bottom and back side.

10. Laptop stand. Get the monitor on your laptop up in the air (**https://uncagedergonomics.com/blog/ten-reasons-to-use-a-laptop-stand/**). We have heard about mobile device neck; the same thing will happen when looking down at your laptop monitor for hours.

Listen to your body. If you get up from a work session feeling achy, crampy, and otherwise uncomfortable, that is a sign that your setup has a problem. While these expenditures can be tough financially, but it you operate from the most likely truth—remote workplace arrangements are long term arrangements.

CYBERSECURITY WAS A VICTIM OF THE PANDEMIC, TOO

Tessian's "Back to Work: Cybersecurity Behaviors" report (**www.tessian.com/resources/back-to-work-cybersecurity-behaviors-report**) indicated that a third of employees picked up bad cyber habits during the work at home phase of the coronavirus pandemic. Of biggest concern to firms should be preventing these behaviors from entering the workplace and preventing them from becoming long-term issues as the remote workplace matures. The IRS's Security Summit (SS) team has been sounding the alarm about a growing problem of incursions into accounting and tax firms' cyber workspace. The SS group reported that 222 firms reported data theft to the IRS in 2021 for the period January 1, 2021–June30, 2021—a number which represented almost the entire year of data breaches for 2019.

Firms continue to move staff remotely without giving serious consideration to the security profile of the remote worker's workplace. Like the security checklist used at the office, the same should be employed at a worker's remote location. Security controls are always a concern for accounting and tax firms, and the less secure nature of home networks makes cybersecurity oversight even more important.

Cloud computing infrastructure has helped to facilitate the movement of production from the office to the home. However, there are other cyber threats that need to be considered in the telecommuting world.

What will it mean if most of the workforce goes remote long-term or moves from home to office and then back home again? There is mounting evidence that either the remote worker trend or the more likely "hybrid model" will become the new normal. There is much concern that COVID-19 will explode again. However, we are just as likely to be attacked by other pandemics in the future. IT resources will be tested as both internal and external demand create an inability to support widely separated users and create the following challenges:

1. Connectivity and bandwidth failures. What does the enterprise do with the at home worker who lives in a remote area with poor internet service?

2. Strained supply chains. For some items, the concept of deciding today that I need it tomorrow is no longer feasible. Some of those items are an issue when more items are needed (e.g., webcams). Others are a function of the manufacturing environment; the company that builds the hard drive is remote, or a manufacturer who has been shut down by issues affecting their workforce.

3. Employees working on personal devices. For example, it is challenging to find a home system that has installed a firewall.

4. Multiple points of network access. The convergence of security problems with multiple points of entry into the data systems of the firm will create more opportunities for cyber thieves.

REMOTE WORKING SECURITY CHECKLIST

Checklists work because they help us remember to do something. Use these thoughts to create the remote worker security checklist. This list should be dynamic—even the author remembered a few issues when reviewing this article. (**www.upguard.com/blog/working-from-home-security-tips**).

- ☐ Secure the Home Office. Most staff are not equipped to implement security from their home. Provide resources to the staff to protect the firm's data.

- ☐ Secure the Home Router. Security experts continue to observe home networks that have not changed the default login and passwords of modems and routers. For many of these devices these defaults can be found with a quick internet search of a manual for a "Century Link" modem.

- ☐ Separate Work and Personal Devices. Once again the staff will need help from the firm. Sending the worker home with a "company" device is the easy answer but is also the most expensive. The perfect world will be not allow company work on personal devices.

- ☐ Turn on the Encryption of the Device at Home. BitLocker (Windows) and FileVault (macOS), FYI Android and iOS are enabled by default.

- ☐ Use a Supported Operating System. Many people (including out staff) still use XP, Win7, or Win 8 on their home computer. According to various sources the exact number of “unsupported operating systems” is difficult to exactly quantify but there is believed to be 10%-15% of all computers attached to the web.

- ☐ Keep the Operating System Up to Date. Sounds easy but another huge vulnerability of the home computer. Tip. At the beginning of the pandemic when the author’s office sent people home, we invested in a visit from our IT company to each worker’s home. Most were grateful, however one person refused.

- ☐ Keep Software Up to Date. See our prior statement.

- ☐ Enable Automatic Locking. When you walk away from a device it cannot be accessed without entering the credentials of the device. Best practices says 30 seconds for mobile devices or 5 minutes for laptops and desktops.

- ☐ Use a Strong PIN/Password on the Device. Annoying but necessary and often not done in homes. Typically, only trusted people ever enter homes, except for maybe, cleaning services, maintenance people, landlords, etc.

- ☐ Use Antivirus Software. Buy it and install it.

- ☐ Invest in a Password Manager. Too many people use the same login and password repeatedly. Failing that they forget their “easy to remember” passwords. An encrypted password vault helps create stronger passwords and remember those easy to remember passwords that we all forget.

- ☐ Enable Two-Factor Authentication and Use an Authenticator App. Two-factor authentication can dramatically reduce the risk of successful phishing emails and malware infections because even if the attacker is able to get your password, they are unable to login because they do not have the second piece of evidence. To successfully login, they would need access to whatever is generating your one-time code, which should be an authenticator app or security key.

- ☐ Enable Find My Device and Remote Wipe. Mobile devices that are lost or stolen need to be wiped of all data ASAP. It is bad enough to lose a $1,000 phone or tablet but the data on the device is worth even more.

- ☐ Wipe Any Devices Before Sharing, Selling, or Disposal. Return the device to its factory settings. Those apps that completely delete the data are on the hard drive should be used judiciously as it will destroy the operating system, which does make the device useless. However, if you are donating the device to an organization, transfer the operating system with the hardware.

- ☐ Use a VPN. (See the following discussion.)

Steps to Protect the Firm’s IT Systems

1. Add remote work standard operating procedures to the IT policy.
2. Plan for more personal devices connecting to the firm network.
3. Take into consideration the nature and character of the personal devices that might be accessing the network.

Consider the requirement/support of using a virtual private network (VPN), especially in public places such as coffee shop hotspots. The number of VPN providers is exploding in the current pandemic environment. Not all VPN providers are created equal, though, and finding the right one can be a tricky process. For a list of reputable VPN providers, visit **www.cnet.com** and search "best VPN service 2021" (**Note:** CNET's search function works best if you include the quote marks). Pricing normally ranges from $50 to $150 annually. *Do not use a free VPN service.* That is not the same as a free trial period, which many VPN services offer, and which we recommend.

When looking at a VPN, be mindful of where the service is hosted. Your data will be on those servers and subject to the data laws of the hosting country. The CNET information previously referenced is helpful for understanding some of the types and unique serviceability issues of the various VPN services.

Encourage a wired connection as it will help connectivity issues. In addition, a wired connection is most often set up with the appropriate security levels versus Wi-Fi which may be plugged in and attached without setting up the necessary security protocols.

Ensure that home workers are running the necessary updates and patches and that they are rebooting their machines. Consideration may be given to having the firm's IT staff review the home system. This can be accomplished remotely with each system taking no more than half an hour. Steps to take include the following:

1. Determine that the home worker is running the necessary antivirus applications.

2. Use two-factor authentication on everything.

3. Educate the team about what new threats are occurring. Engage in open and transparent cybersecurity training.

4. Carefully review incident response plans, ensuring that the remote workforce is considered for the implementation of that plan.

Take the necessary steps to protect remote workforce resources as quickly as possible. Future modifications should be acutely aware of that home resource. Whatever infrastructure can be hosted in the cloud will make the process less difficult. The browser is the connection, which will not solve connectivity issues of bandwidth, but will protect the data of the firm. This will also allow a quick response to any kind of emergency. Also consider—

1. Applications. Software as a Service (SaaS)

2. Desktops. Virtual Desktops (DaaS): While a little pricey, Microsoft now offers a virtual desktop.

CONVERSATIONS TO HAVE WITH REMOTE WORKERS

Physical Security

Physically securing the office *must* occur. Workers who are setting up at the dining room table are not long-term remote or hybrid worker candidates. Just as you lock up the office when you leave for the day, do the same when working from home. Laptops can be stolen from your backyard, living room, dining room, or home office. Take the laptop inside when going in to make lunch and lock the home office door. Keep the home workspace as secure as the normal office.

Electronic Security

Changing the router's password from the default to something unique is a simple step toward protecting the home network from malicious actors who want access its connected devices. While changing the router password is a good first step, there are additional actions the worker should be familiar with, such as, ensuring router firmware updates are installed as soon as possible to mitigate any known vulnerabilities.

Separate Work and Personal Devices

This is going to be a tough one and may require a financial commitment on the part of the firm. While there is hopefully a policy at the office prohibiting accessing personal sites, the dividing line is more difficult to discern at the “home office.” Make sure the home worker understands this, as those things left unsaid most frequently get ignored.

Antivirus on the Remote-Work Computer

A significant number of firms will not have the resources to purchase a computer for the home worker, and just as importantly, the home worker may not have the space to place a second computer. Most home computers come with basic antivirus (AV) software installed with the operating system, but firms should invest in AV software that the firm controls.

Ransomware

The best ransomware preventative is a highly attentive worker. The IRS and the Security Summit team has been extremely vocal about the number of firms that have been attacked by ransomware through home office connections. Kaspersky and others report that ransomware attacks a machine every five seconds.

Virtual Private Network

HP, Inc. reported the following in a recent survey:

- 37% of workers are regularly using personal home devices to connect to the business network,
- 32% have used their person devices to connect to the corporate network servers,
- 34% are using their home printer to scan and share documents with colleagues and customers, and
- 21% have used their home printer to save files to the office file system over the VPN

Security policies and checklists are an important part of a sound cybersecurity profile. However, having someone who is part of the IT data management system is even more important.

COMPLIANCE RISK

Ever since COVID-19 shut down offices and converted desk workers into remote workers, tax professionals have been bracing for the consequences. Most have viewed this situation through the lens of compliance and risk.

Remote work may be a tax savings opportunity as well. A firm may be able to save payroll taxes when workers no longer work in areas that often have higher payroll tax burdens, such as when employees who would normally work from offices in New York City, Seattle, or San Francisco choose to work temporarily or permanently from alternative locations.

IS REMOTE WORK A TICKING TIME BOMB?

Many workers have worked outside of their home state or country since the beginning of the COVID-19 pandemic. More troubling is when they fail to report days spent working in other jurisdictions and the resultant tax compliance implications.

This tax compliance risk from employees working remotely in multiple tax jurisdictions is likely to endure (see additional worker nexus discussion in Chapter 28). With employees believing they should be able to work from the location of their choosing so long as they get their work done, coupled with the belief that increased remote work will foster more diverse teams, few firms seem eager to force remote employees back into the office.

Unmanaged remote work poses risks for enterprises and blind spots for tax professionals. Remote employees may forget to report their location daily. They may intentionally mask their post-COVID location to ensure that their employer will not reduce their salary to match their new local cost of living. Despite the HR professionals' confidence, the Adapt Survey suggests that few organizations know where their employees have worked throughout the pandemic or where they are located now.

A survey commissioned by the real estate company JLL found that half of office workers want to work part-time from an office and part-time from home (a so-called "hybrid" model), while a quarter want to work remotely full-time. Employers may find it difficult to resist this shift. 94% of 800 U.S. employers surveyed by Mercer said that post-COVID productivity was the same or higher, even with employees working from home.

An Adapt Survey found an overwhelming majority of employees said they would be comfortable with an employer tracking their location at the country, state, and city scale. That is sufficient detail for tax compliance, particularly for savings opportunities around New York, Seattle, and San Francisco. Smartphone- or computer-based software could perform this location tracking automatically for employees willing to opt-in.

The evidence suggests that remote work will continue after COVID-19, and few organizations are equipped to manage the associated compliance risks or take advantage of potential tax saving opportunities. Tax professionals would do well to raise this issue with clients now, as their organizations debate what their physical footprint and remote work policies will look like in a post-pandemic world.

Changing to the hybrid or remote work model is not just sending the worker home with a laptop. The bottom line is clear: switching from a commercial office practice to a home-based one involves different kinds of risks and requires thoughtful changes to protect yourself uninsured civil liability. Before making such a change, consult with an attorney who has expertise in tort litigation in addition to an experienced insurance professional to identify and eliminate or substantially reduce exposure.

VIRTUAL MEETINGS

One of the biggest changes caused by the pandemic is the use of the virtual video conference (VVC). At some point or another, everyone has joined a VVC where everyone but one person has turned on their cameras. People need visual reinforcement for effective decision-making. Getting comfortable with the camera is a skill everyone needs to master. Several steps can make the VVC a more enjoyable and effective experience include—

1. Ensure the background looks as professional as possible.

2. Check the lighting and avoid backlighting. You want your face to be visible to the audience. If are using a notebook computer with a camera, consider elevating the computer with a stand or a pile of books so that the audience sees you straight on.

3. As with in-person meetings, choose the wardrobe based on the nature of the meeting. Dress to fit the character and nature of the meeting group. Some meetings will demand a coat and tie (pants could be optional) and others are just fine with a t-shirt.

4. Make the computer's desktop ready for the event:

    a. Open all required documents and webpages.

    b. Close those windows not required for the event.

    c. Share what is relevant and hide the rest.

    d. Mute notifications and hide the browser's bookmarks bar.

Another concern is when it is your turn to host the VVC. The following steps will be helpful when this is the case:

1. Plan the agenda:

    a. Keep the conversation interactive—avoid making the event a lecture and do not run through an endless series of slides.

    b. Engage the audience and plan the dialogue for what will happen.

    c. Ask questions along the way.

    d. Try to include video and/or webpages with interactive content.

    e. Know the material well enough to allow jumping to the most salient part of the discussion.

These same skills can be used as an attendee:

1. Practice:

    a. <u>Fine tune the setup.</u> The big presentation is not the time to figure out that your equipment needs some tweaking.

    b. <u>Test the microphone.</u> Many video conference apps have microphone settings separate from your computer settings. Determine that you know how to mute/unmute the audio.

    c. <u>You are in a video environment, time to be a movie star.</u> Determine the best position/angle of your camera. Understand how to turn your camera off and on. If your video does not turn on, do not panic, check to see if some other application that uses the camera has the video dedicated to what it is doing (see 2a).

d. Learn and practice the many features of your video chat application. Some of the examples can include sharing screens versus specific windows, showing and hiding non-video participants, and pinning videos.

2. Set expectations:

    a. Inform your participants that the call will be a video chat. Most applications will provide a process for accepting/declining the event. Ensure that the invite indicates it is a video event. Be prepared to address the issue of those who choose to dial in only.

    b. Have instructions on what steps are necessary for first-timers.

    c. When possible, ensure each participant has their own screen, even if they are in the same physical location. In the event your organization holds frequent VVC, it may be advantageous to set up your conference room with a webcam and wireless speaker. A large-screen TV monitor can work well in this environment also.

3. Run the show:

    a. Determine that everyone's equipment is working.

    b. You are in charge of the event; set the agenda. Virtual meetings have the potential to get out of control. There are other features that can help smooth out the dialogue, such as the chat feature and raise your hand if you wish to speak.

    c. Call people by name. If you have difficulty with names, there is normally a feature to label the image with a name. This may happen automatically as the attendees' computers identify themselves.

    d. Remember this is not a playground but a business meeting—etiquette is part of the event. However, remember to relax, have fun, and be yourself.

4. Monitor body language:

    a. If someone looks confused, clarify.

    b. When people are learning forward or attentive, they are engaged; if not, attempt to rectify.

    c. Avoid eating during the call and be sure to mute your audio and/or turn off your camera when appropriate.

    d. Pause between speakers to allow the topic of the last discussion to be absorbed.

5. End on a positive note:

    a. End the conference at the scheduled time or earlier.

    b. Set clear steps at the end for the action items and get consensus from the participants in attendance.

> **OBSERVATION:** When clients are initially presented with the idea of a VVC, they are often reluctant. The value of a face-to-face conversation is an important skill learned over the years. Gently nudging clients to be comfortable with the VVC will be a valuable tool to your firm and create acceptance of your firm as an innovation leader.

Video Conference Apps

Choosing a conferencing app can be a daunting task. There are numerous players in the free app market; however, the free apps usually limit either the number of participants, the length of the meeting, or both. The technology commentary service "How to Geek" recently reported its rating of the following five free conferencing services (visit **www.techradar.com/best/best-video-conferencing-software** and search "the best video conferencing apps 2021"), below find a list of the big 5:

1. <u>Go to Meeting.</u> A standalone web-conferencing service provided by LogMeIn. As expected, it provides audio and video conferencing, as well as screensharing.

2. <u>Ring Central Video.</u> They offer the full range of industry-standard features across all its plans. These include video call scheduling and recording, screen sharing and annotation, built-in chat functionalities and much more.

3. <u>Microsoft Teams.</u> This is a full-range communication system that enables users to schedule video or audio meetings with a single person or a team. Administrators can also organize webinars and large meetings with up to 10,000 participants. The product is fully integrated with MS Office 365.

4. <u>Google Meet.</u> Formerly Google Hangouts, Meet, is part of the Google Workspace office productivity platform (formerly known as G Suite). Having enjoyed a recent rebrand, Google Meet aims to provide a first-class conferencing service.

5. <u>Zoom Meetings.</u> Offers a video conferencing and messaging solution for desktop and mobile devices that aims to be quick and easy to set up and offers a wide range of scalable features.

WHERE TO GO FOR MORE INFORMATION

- "Tips for Working from Home from a Guy Who's Been Doing It for a Decade" at **www.reviewgeek.com**

- "Everything You Need to Set Up a Productive Home Office" at **www.reviewgeek.com**

- "How to Work from Home and Get Stuff Done" at **www.lifesavvy.com**

CHAPTER 34: PASSIVE AND RENTAL ACTIVITIES

Learning Objectives

Completion of this chapter will enable participants to—

- Define passive and rental activities and related carryovers.
- Determine when to use elections for grouping activities and real estate professionals.
- Determine the impact of the 3.8% Net Investment Income Tax (NIIT).
- Apply rules for self-charged interest income and mixed-use property.

CONCEPTUAL FRAMEWORK

IRC Sec. 469 was the centerpiece of the Tax Reform Act of 1986 and was written to put an end to tax shelters. More specifically, it defers most passive activity losses (PALs) until either a taxpayer recognizes income from an activity and/or other passive activities or disposes of the activity entirely.

The passive activity rules create three separate baskets of income and loss: passive, portfolio, and nonpassive. Losses and credits generated by passive activities are segregated from portfolio and nonpassive income. Passive activity losses (PALs) may not offset income in the other two categories.

> **PLANNING TIP:** A former passive activity's income can be used to offset suspended passive losses of that same activity under IRC Sec. 469(f)(1).

Unused PALs and credits are carried forward to the following year when they may be applied against passive activity income for the year (or subsequent years). Carryforward losses continue until the taxpayer disposes of the property, gifts the property to another individual or dies.

There are two types of passive activities:

1. An activity that involves the conduct of any trade or business in which the taxpayer does not materially participate (IRC Sec(s). 162 and 174), and
2. Rental activities, which are presumed passive unless the taxpayer can meet the real estate professional designation [IRC Sec. 469(c)(2)].

Passive activity shall not include any oil or gas activities that qualify as a working interest where the taxpayer's ownership does not limit liability [IRC Sec. 469(c)(3)(A)].

MATERIAL PARTICIPATION TEST

Under Reg. §1.469-5T, a taxpayer shall be treated as materially participating in an activity for the taxable year if, and only if, the taxpayer meets at least one of seven tests:

1. The taxpayer participates in the activity for more than 500 hours during the year.

2. The taxpayer's participation in the activity constitutes substantially all the participation by all individuals (including non-owners) during the year. The term substantially is not defined in the regulations.

3. The taxpayer participates in the activity for more than 100 hours and no other individual (including non-owners) participates more hours than the taxpayer during the year.

EXAMPLE: Material participation test—participation between 100 and 500 hours

Gill is employed fulltime as a chef at Blue's Seafood and owns an interest in an LLC that makes fried fish products. This is a trade or business activity within the meaning of Reg. §1.469-1T(e)(2).

Gill and Sonny (the other partner) are the only participants in the activity for the taxable year. The activity is conducted entirely on Saturdays. Each Saturday throughout the taxable year, Gill, and Sonny work for eight hours in the activity.

Neither Gill nor Sonny participate in the activity for more than 500 hours during the taxable year. However, each is treated as materially participating in the activity because each participates in the activity for more than 100 hours during the taxable year and neither Gill's nor Sonny's participation in the activity is less than the participation of any other person in the activity. Therefore, Gill can deduct his losses (if any) in the LLC.

Variation: Assume the same facts, except the fish business has a net profit. Also, assume Gill owns a rental property with losses. If Gill wants to offset his rental loss against his fish income, he needs to work fewer hours during the year than Sonny. If Gill works one less Saturday than Sonny during the year, he will fail the material participation test and the activity would be treated as passive. Gill may use his rental loss to offset the fish income.

COURT CASE: In *Leland*, a taxpayer handled all the infrastructure of a Texas farm, including the removal of wild hogs. The hours he spent were more than the hours of the farmer who entered into a crop-share arrangement with the taxpayer. The Tax Court agreed with the taxpayer that the hours were over 100 and more than anyone else (*Leland v. Comm.*, TC Memo 2015-240).

4. The activity is a significant participation activity, and the taxpayer's aggregate participation in all significant participation activities during the year exceeds 500 hours [Reg. §1.469-5T(c)];

NOTE: A significant participation activity is any trade or business activity (other than a rental activity) in which the taxpayer participates for more than 100 hours but does not materially participate under any of the seven tests except this one. The activities can be properly grouped together as one activity under Reg. §1.469-4(c).

COURT CASE: The Tax Court held in *Brumbaugh* that where a taxpayer who was the majority owner and an active employee of a real estate C corporation formed a partnership with his wife, and the partnership purchased a plane for use in the real estate business and engaged an aviation management company that managed the plane and also rented it out when the C corporation wasn't using it, the real estate business and the plane activity could not be combined for purposes of determining whether the taxpayer materially participated under the passive activity loss (PAL) rules.

The Court held that, even if the taxpayer had proven that he devoted the required 100+ hours to the plane LLC, he did not meet the second prong of the "significant participation" test, which requires that the taxpayer devote 500+ hours in the aggregate to "significant participation activities" (*Brumbaugh v. Comm.*, TC Memo 2018-40).

5. The taxpayer materially participated in the activity for any five years (not necessarily consecutive) during the 10 immediately preceding years.

6. The taxpayer materially participated in a personal service activity for any three years (not necessarily consecutive) during any preceding years. Personal service includes the fields of accounting, architecture, actuarial science, consulting, engineering, health, law, performing arts, or any other trade or business in which capital is not a material income-producing factor); or

7. Based on all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year [Reg. §1.469-5T(a)(7)]. Participation of less than 100 hours during the year precludes the taxpayer from using facts and circumstances to establish material participation [Reg. §1.469-5T(b)(2)].

COURT CASE: In *Barbara*, the taxpayer had a lending business in Chicago with losses and the IRS proposed taxes and penalties calling the losses passive because the taxpayer split his time between Chicago and Florida and lived in Florida 60% of the year.

Does living in Florida for part of the year mean that a business owner could not materially participate in his Chicago lending business? The court determined that he spent 460 hours or more working in Chicago and another 240 hours a year working in Florida and that it made no difference that he worked from a remote location. With total hours over 700 each year the court ruled he materially participated each year. Curiously, material participation was allowed under Reg. §1.469-5T(a)(7), the facts and circumstances test, and not the first test under Reg. §1.469-5T(a)(1), the 500 hours test. [*Barbara v. Comm.*, T.C. Memo 2019-50]

Taxpayers can substantiate material participation, using any reasonable method. Contemporaneous daily time reports, logs, or similar documents *are not* required if the extent of such participation may be established by other reasonable means. *Reasonable means* may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries [Reg. §1.469-5T(f)(4)].

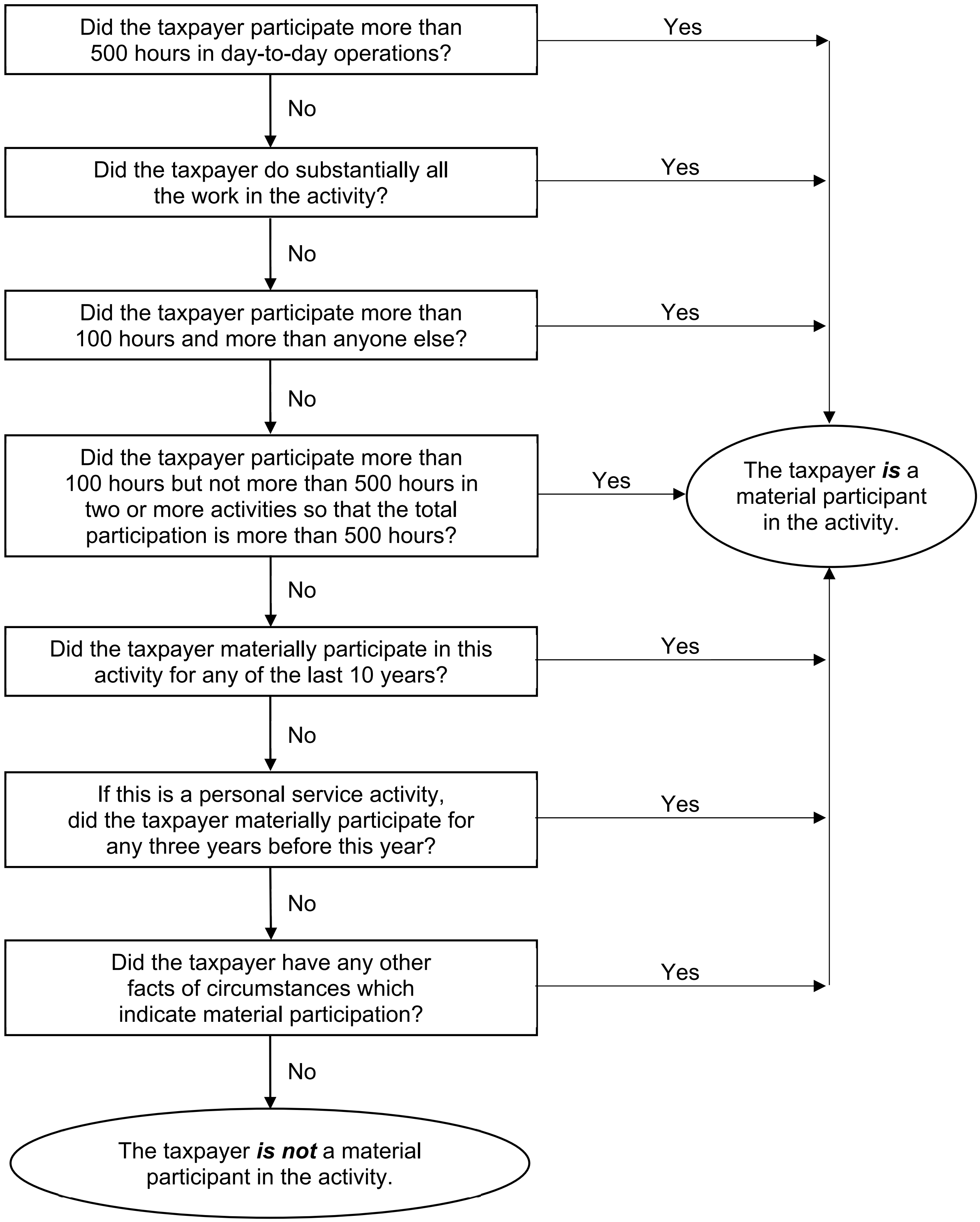
CAUTION: Six of the seven tests that prove material participation in an activity require proof of time spent. The courts have repeatedly found in cases where the hours are close to the minimum requirement that oral testimony alone does not establish material participation. Taxpayers should keep detailed written records of their activities.

COURT CASE: In *Tolin*, the taxpayer was an attorney in Minnesota who also ran a horse breeding venture in Louisiana. He claimed losses for three years from the thoroughbred activity and the IRS disallowed them based on the fact they were passive activity losses. The taxpayer won the argument that he had spent more than 500 hours using telephone records, credit card invoices and other contemporaneous materials. In Tolin I (TC Memo 2014-65), the court concluded he had indeed materially participated. Here, in Tolin II, the taxpayer sued the court for an award seeking his litigation costs and was finally awarded $180 an hour, not the $400 per hour he was seeking. (*Tolin v. Comm.*, TC Memo 2018-29)

Any participation in an activity by a spouse (even if he does not own an interest or file jointly with his spouse) is treated as participation in the activity by the taxpayer [Reg. 1-469-5T(f)(3)]. However, if the work performed by the taxpayer or spouse is not of a type customarily done by a business owner, or is done primarily to avoid the disallowance rules, then the work does not count as material participation [Reg. §1.469-5T(f)(2)(i)].

Limited partners are generally treated as if they don't materially participate. They must pass test 1, 5, or 6 above to qualify [Reg. §1.469-5T(e)(2)]. LLC members are not limited to the previous three tests and can use all seven tests (*Garnett v. Comm.*, 132 TC 368).

TESTS FOR DETERMINING MATERIAL PARTICIPATION (IRS SEC. 469)



RENTAL EXCEPTION TEST

The term *rental activity* means any activity in which payments are principally for the use of tangible property [IRC Sec. 469(j)(8)]. However, an activity involving the use of tangible property is not a rental activity for a taxable year if, for such taxable year [Reg. §1.469-1T(e)(3)(ii)]:

1. The average period of customer use or rental is seven days or less (e.g., auto, tool, or tuxedo rentals). Some vacation rentals have an average period of customer use of seven days or less, which means that the activity is not a rental activity and must meet the material participation test to deduct any losses.

2. The average period of customer use is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers (e.g., a hotel or other temporary lodging with housekeeping and/or other valet services).

3. Extraordinary personal services are provided by or on behalf of the owner without regard to an average period of customer use. The services must be performed by individuals, and the use of the property by customers is incidental to their receipt of such services (e.g., a patient's use of a hospital's boarding facilities is incidental to their use of the medical and nursing personal services, or a student's use of a school's dormitories is incidental to their use of teachers' personal services).

COURT CASE: In *Assaf, et ux*, a taxpayer provided substantial support services to tenants. The tenants leased space exclusively for the benefit of those services. Specifically, the taxpayer provided tenants a paralegal, a legal intern, a law clerk, an up-to-date law library, a computer with legal research capabilities, and two conference rooms. The taxpayer further provided tenants with employees to perform client intake, answer phones, file documents with the courts, perform secretarial duties, and perform legal research. The Tax Court held that these were extraordinary personal services and therefore the rental activity was not passive (*Assaf F. Al Assaf, et ux. v. Comm.*, TC Memo 2005-14).

4. The rental of the property is treated as incidental to a non-rental activity of the taxpayer. This applies when the annual gross rental income from the property is less than 2% of the lesser of the unadjusted basis of the property or its FMV. The taxpayer must use the property predominantly in a trade or business and own an interest in the activity during the year (or during at least two of the five preceding years);

EXAMPLE: Determining treatment of rental activity

Al owns 1,000 acres of unimproved land with a FMV of $350,000 and an unadjusted basis of $210,000. He holds the land for the principal purpose of realizing gain from appreciation. To defray the cost of carrying the land, he leases the land to a neighboring farmer to graze alpacas for $4,000 per year.

The annual gross rental income from the land is less than 2% of the lesser of the FMV and the unadjusted basis of the land (0.02 × $210,000 = $4,200). Accordingly, the rental of the land is not a rental activity because it is treated as incidental to the activity of holding the property for investment.

5. The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers (e.g., a golf course or health spa); or

6. The taxpayer, who has an interest in a property, provides the property for use in an activity conducted by a partnership, S corporation, or joint venture, as long as the activity is not a rental activity (e.g., a partner contributes the use of property to a partnership, and none of the partner's distributive share of the partnership's income is rental income, unless the partnership is engaged in rental activity).

PLANNING TIP: An activity involving the use of tangible property that is not a rental activity for a taxable year under one of the exceptions at Reg. §1.469-1T(e)(3)(ii) is reported on Schedule C and Schedule SE.

However, both the revenues and related expenses associated with the rental of personal property for profit when the taxpayer is not in the trade or business of renting property is reported on Schedule 1, Additional Income and Adjustments, Form 1040.

COURT CASE: In *Sciabica*, shareholder owned an interest in an S corporation and rented automatic scoring equipment to the corporation, which owns bowling alleys. The Tax Court held that the taxpayer did not provide property to the S corporation, but leased property to the S corporation. The equipment was provided by the shareholder to the S corporation in his capacity as a lessor and not a shareholder. In other words, it was a rental (*Vincent Sciabica v. Comm.*, TC Summary Opinion 2002-146).

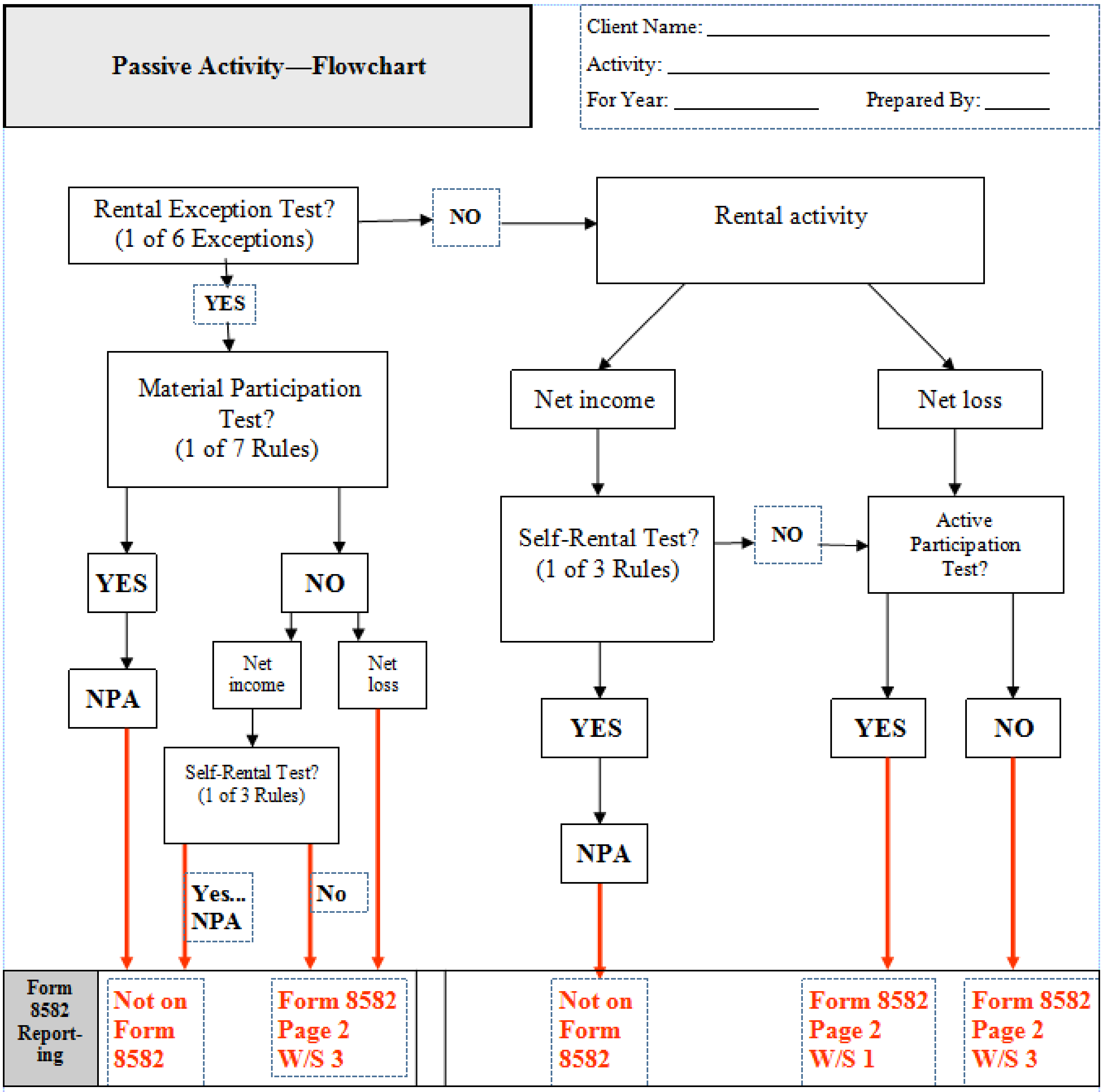
COURT CASE: In *William Bruce Costello et al. v. Comm.*, TC Memo 2021-9 the taxpayer and his wife were engaged in a rental real estate activity in which they reported a loss on one property. The IRS disallowed the loss deduction on the rental property on grounds that it was not held for rental because it had been flooded, was in no condition to rent, and had not been advertised for rental. The IRS disallowed the sum of operating deductions for other rental properties as a passive loss. In determining the passive loss, the IRS took no account of a substantial gain from the sale of two of the taxpayer's rental properties.

The tax court held that the disallowance of the operating loss deduction for the first rental property was sustained because it was not held for rental. However, in determining the overall passive loss, the court found in favor of the taxpayer.

PASSIVE ACTIVITY DECISIONS

The following flowchart was designed as a helpful tool to follow and document the decision process when determining if any activity is a passive activity. Portfolio activities are excluded from this analysis and are not considered passive activities. Each test (rule) is described later in this chapter.

Flowchart for Passive Activity Decisions



PLANNING TIP: The author recommends that practitioners document each trade or business (including Schedules K-1) and passive activities in a separate flowchart for every client. This will document the decision process in case of audit.

See Chapter 40, IRC Sec. 199A—Qualified Business Income Deduction (QBID), for a comprehensive discussion of the 20% deduction for a taxpayer's qualified business income from a rental and/or a passive activity.

ACTIVE PARTICIPATION TEST (RENTAL LOSS)

Rental activities are presumptively passive unless the taxpayer can meet the real estate professional designation.

There is a special test for rental real estate losses. If the test is met, rental real estate losses may be deducted up to $25,000 by a taxpayer whose modified adjusted gross income (MAGI) is $100,000 or less (AGI without certain adjustments, including but not limited to, taxable social security benefits, deductible IRA contributions, deduction for student loan interest).

To qualify for the deduction, a taxpayer must actively participate as defined below. The $25,000 deduction is phased-out at the rate of $0.50 for every dollar of MAGI over $100,000. Therefore, when a taxpayer's MAGI reaches $150,000, the deduction disappears.

NOTE: The $25,000 deduction is not available to taxpayers who file married filing separate and live together at any time during the year [IRC Sec. 469(i)].

The active participation standard is much less stringent than the material participation standard. Taxpayers are deemed to be actively participating if they participate in management decisions in a bona fide sense. There are no specific hour requirements, but taxpayers must exercise independent judgment and not simply ratify the actions of a manager/management company.

PLANNING TIP: Management decisions that may count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions.

Flow-through rental real estate losses can qualify for the deduction as long as the taxpayer meets the active participation standard. Limited partners, and anyone who owns less than 10% of an activity, *cannot* meet the active participation standard. Active participation *is not* met if losses are from an entity under a net lease.

Casualty or theft losses related to rental real estate can be deducted as part of the $25,000 deduction. Losses in excess of the $25,000 deduction can be taken as casualty or theft losses.

COURT CASE: The Tax Court ruled in *Agosto* that a taxpayer could deduct a casualty loss on a rental property in addition to passive activity losses of $25,000. The loss satisfied the exception under Reg. §1.469-2(d)(2)(xi) for certain casualty and theft losses. The loss was not a passive activity deduction because it satisfied three requirements: (1) the loss was caused by a fire (theft or other casualty losses could also qualify); (2) similar losses do not occur regularly in the conduct of the activity; and (3) the loss occurred after 1989 (*Agosto v. Comm.*, T.C. Summary Opinion, 2009-191).

SELF-RENTAL TESTS (RECHARACTERIZATIONS)

The self-rental test can block a taxpayer with passive activity losses (losses arising from a rental activity or any activity where the material participation rules were not met) from artificially creating passive activity income in order to absorb those losses.

NIIT regulations state that recharacterized income from self-rental for regular tax purposes will be treated as recharacterized income for NIIT purposes also. In other words, since it is treated as nonpassive income for NIIT purposes, it is not subject to NIIT.

PLANNING TIP: Many self-rental clients will have net rental income (not loss). They would report income for regular tax purposes, but by properly classifying the self-rental income as nonpassive they will avoid the 3.8% NIIT.

When a taxpayer rents real property or equipment to a trade or business activity in which he materially participates (as defined by Reg. §1.469-5T), net rental income from the property is recharacterized as nonpassive income. Conversely, a net rental loss from the property is treated as a passive loss.

EXAMPLE: Treatment of passive and nonpassive rental income

Bean owns all the stock of Weapons of Mass Deduction, Inc. (WMD), an accounting firm operating as an S corporation and is employed full-time as an accountant by the company. He rents a building he owns to WMD (the lease was established in 2019). The gross rental income Bean receives is $25,000 for the year and rental expenses are $10,000 for a $15,000 net profit. He has passive losses from another Florida rental house totaling $17,000.

The $10,000 rental expenses are deductible against the rental income. The remaining $15,000 of rental income is recharacterized as nonpassive. Bean has no other passive income, and the $17,000 passive loss is suspended and is not deductible in the current year. The rental income is also recharacterized as nonpassive for NIIT purposes and will not be subject to NIIT.

The self-rental test applies if a taxpayer rents property to a closely held C corporation in which they materially participate [Reg. §1.469-11(c)(1)(ii)].

COURT CASE: The 5th Circuit Court of Appeals affirmed the Tax Court ruling in *Williams* that rental income received in a 100% owned S corporation was self-rental because it came from a 100% owned C corporation medical practice. The court treated the income as nonpassive, and the taxpayer could not use it to offset passive activity losses. (*Williams v. Comm.*, 117 AFTR 2d 2016-600)

If less than 30% of the unadjusted basis of a rental property is subject to depreciation, any net income is treated as nonpassive. Leasing undeveloped land, mobile home parks and activities involving ground rents are all examples [Reg. §1.469-2T(f)(3)].

EXAMPLE: Effect of recharacterizing rental income as nonpassive

Pinto owns an empty lot located near an auto dealership. He rents the lot to the dealership, who uses the lot to park their overflow stock of automobiles and trucks. Pinto has net income of $30,000 from renting the lot to the dealership and he has other passive rental losses of $30,000. Assuming Pinto's MAGI is over $150,000, he will not be able to use any of the passive losses and they will carry forward. The lot rental income is recharacterized as nonpassive and may not be offset by passive losses. The lot rental income is also recharacterized as nonpassive for NIIT purposes and will not be subject to NIIT.

REAL ESTATE PROFESSIONALS

IRC Sec. 469(c)(7) pertains to rental real estate activities of certain qualifying taxpayers. Rental activities of qualifying individuals are not presumptively treated as passive. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under IRC Sec. 469 for the taxable year unless the taxpayer materially participates in the activity.

To qualify for this tax break, the taxpayer must satisfy both of the following tests:

1. More than 50% of all personal services performed in trades or businesses by a taxpayer during a tax year are performed in real property trades or businesses in which the taxpayer materially participates, and

2. Taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates [IRC Sec. 469(c)(7)(B)].

COURT CASES: In *Hairston*, the Tax Court found that a taxpayer's calendars did not provide enough proof that he materially participated in 750 hours of service on his rental properties.

Mr. Hairston owned two rental properties. He performed various activities related to the properties including performing maintenance on the property such as cutting grass and removing snow, remaining onsite while workers were performing major maintenance on the property, advertising the properties, fielding questions from prospective tenants, showing the properties to applicants, and screening applicants with credit reports and background checks.

For 2014, his expenses of maintaining the properties exceeded his income from the properties. Mr. Hairston deducted that net loss from his other income.

Mr. Hairston maintained a calendar for each rental property that purported to show the number of hours worked each day. The calendars included 360 separate entries and showed he performed 750 hours of service in 2014.

The IRS disputed the number of hours worked and determined that he did not materially participate in more than 750 hours of service. The Tax Court agreed with the IRS that Mr. Hairston did not provide enough proof to show he performed 750 hours of service.

The Court found that the hours recorded on the calendars lacked credibility for several reasons. One, every task recorded on the calendars, no matter how trivial, was listed as having taken at least one hour to complete. These included 36 entries for doing nothing more than receiving a rent payment, issuing a receipt for a payment, or depositing a check at the bank. There were 13 distinct one-hour entries for "paying mortgage."

The Court found that this inflationary pattern was also found in calendar entries recording time that Mr. Hairston allegedly spent supervising contractors. He recorded many hours during which he allegedly watched contractors work, including 33 hours while they installed and cleaned carpet. During one week in December, he recorded another 40 hours "supervising" contractors who were painting the interior of one of the properties.

More importantly, the Court did not think that that the time Mr. Hairston spent watching contractors qualified as work performed. The contractors were doing the work. The Court concluded, citing Moss, that he was at best "on call" to answer questions from the contractors and lock the house when they finished. So whether he spent 40 hours or one hour watching the painters, this was not time that counted towards the 750 hours. (*Hairston v. Comm.*, TC Memo 2019-104)

In *Hakkak, et al*, the attorney-husband, who held ownership interests in LLCs that held rental real estate, and his homemaker-wife weren't entitled to treat as nonpassive losses from husband's real estate activities that they previously treated as passive under IRC Sec. 469. The taxpayers failed to show that husband qualified as real estate professional under IRC Sec. 469(c)(7)(B) where he didn't meet either personal services requirement or 750-hours test.

Although the taxpayers offered handwritten calendars and documents such as emails, lease agreements, bank account and credit card statements, invoices, loan and insurance documents and property tax records purporting to show that husband handled day-to-day management of rental properties, his vague testimony and abbreviated calendar entries failed to specify how he spent his time or establish that he spent more than half of his personal service hours on his real estate activities. Notably, despite his claims of health problems and limited hours worked as attorney, husband, who produced no calendars or timesheets related to his legal work because he apparently had no such records, still had significant income from his law practice. (*Zaid Hakkak, et al, v. Comm.*, TC Memo 2020-46)

A similar outcome was handed to the taxpayers by the Tax Court in *Larkin v. Comm.* (TC Memo 2020-70).

In *Hickam*, a taxpayer who brokered mortgages and originated loans, but also managed three rental real estate properties did not qualify as a real estate professional. A taxpayer qualifies as a *real estate professional* for a tax year if more than half of personal services for the year are performed by the taxpayer in real property trades or businesses in which he materially participates, and the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which he materially participates. The Court concluded that the taxpayer brokered loans between buyers and financial institutions, and therefore the activity did not qualify as a real property trade or business. The Court said the management of the three rental properties qualified as a real property trade or business, but his hour logs were prepared well after the years at issue and were not reliable. Therefore, he failed to prove that he spent adequate time to qualify as a real estate professional. (*Hickam v. Comm.*, TC Summary Opinion 2017-66).

In *Penley*, a taxpayer had a full-time job as a sterilization tech (2,194 hours worked) for most of the year and was actively involved in selling real estate. Taxpayer claimed 2,520 hours on real estate activities. The court did the math and said, “that means if he worked every day, he would need to have averaged 12.88 total hours per day. We conclude the calendar is untrustworthy, and we will not naively accept it to reach the result petitioners seek.” The Tax Court found that the taxpayer did not qualify as a real estate professional. (*Zane and Monika Penley v. Comm.*, TC Memo 2017-65)

Both of the previous tests require material participation in the rental activity. If a taxpayer does not materially participate in the rental activity, the passive loss restrictions may be unavoidable even if the preceding test is otherwise satisfied.

NOTE: How does the IRS analyze material participation in real estate activity associated with real estate professionals? Most real estate professionals rely on the second test (providing substantially all participation), or the third test (participating for more than 100 hours with no other individual participating more) to meet the material participation standard. On page 2-21 of the IRS’s Passive Activity Audit Guide, the IRS instructs auditors to ask if there is a property manager (employee or non-employee), and to check for large labor expenses that could indicate a hired contractor spent more time engaged in the activity than the taxpayer did. The existence of a management company is a strong indicator that the client does not meet the standard.

NEW COURT CASE: In *Eger*, the district court held that a taxpayer's rental activity was passive, even though the taxpayer was a real estate professional.

The Egers owned rental properties in Mexico, Colorado, and Hawaii. For each of the properties, the Egers entered into management agreements. The management agreements gave the managers the exclusive right to market and rent out the properties. But the Egers could use the properties if they gave advance notice. The Egers, though, never did use the properties. The Egers deducted the losses generated by the properties against their non-passive income under IRC Sec. 469(c)(7). Both parties agreed that Mr. Eger was a real estate professional.

The IRS contended that the seven-day exception applied to the three properties because the average period of customer use for each of them was seven days or less. Under the IRS's approach, the customers were the end-user guests who stayed in the rental properties. The Egers asserted that the customers were the three management companies. Therefore, according to the Egers, the average period of customer use was far greater than seven days, which means that the exception did not apply and, therefore, their rental activity was not a passive activity.

The district court found that the three management companies did not have a continuous or recurring right to use the properties because the Egers retained significant rights to use the properties throughout the year. Therefore, the management companies were not the customers to which the seven-day exception applied. Since the end-user guests were the customers, and they rented the properties for less than seven days on average, the seven-day exception applied, and the rental losses were considered passive. [*Eger v. U.S.*, 124 AFTR 2d 2019-5717 (405 F. Supp. 3d 850) (DC CA)]

PLANNING TIP: Grouping rental properties will often allow the taxpayer to meet the material participation standards.

For the 50% and 750-hour tests, each spouse’s time is considered separately, and each must satisfy the tests individually. However, for determining material participation, the spouses’ time may be combined.

If a taxpayer has several rental activities, a qualifying taxpayer may elect to treat all interests in rental real estate as a single activity [Reg. §1.469-9(g)(3)]. Aggregating all interests in rental real estate makes it easier to meet the material participation requirement:

1. The election is made by attaching a statement to an original return containing a declaration that the taxpayer qualifies as a real estate professional and is treating all rental activities as a single activity pursuant to IRC Sec. 469(c)(7)(A).

2. The election is irrevocable for the current and all future tax years in which the individual qualifies as a real estate professional [Reg. §1.469-9(g)(1)].

CAUTION: Electing to aggregate should be decided carefully. It may be inadvisable for a taxpayer to make this election if there is positive net income from rental real estate activities and passive losses from non-rental real estate activities. In that case, treating the rental real estate activities as passive would be more advantageous, as the taxpayer could use the losses from the other passive activities to offset the income from the rental real estate activities.

NOTE: Rev. Proc. 2010-13 requires taxpayers to disclose activities that have been grouped together or kept separate for passive activity loss purposes. It is not required for real estate professionals.

Qualifying taxpayers may make a late election by attaching an election statement to an amended return for their most recent tax year. Rev. Proc. 2011-34 provides guidance for the late election to treat all interest in rental real estate as a single rental real estate activity. The procedure:

Contains specific declarations and representations required under Reg. §1.469-9(g)(3) in Sections 4.01 and 4.02 of the procedure.

1. Addresses eligibility for relief; and

2. Provides procedural requirements for requesting relief.

A taxpayer is eligible for an extension of time if the taxpayer represents in a statement that they—

1. Failed to make an election solely due to failing to timely meet the requirements in Reg. §1.469-9(g),

2. Filed consistently with having made an election under Reg. §1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election, and has filed all required federal income tax returns consistent with the requested aggregation for all of the years including, and following, the year the requested aggregation is to be effective, and no tax returns with inconsistent positions were filed during any of the tax years,

3. Filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within 6 months after its due date, excluding extensions, and

4. Had reasonable cause for failing to meet the requirements in Reg. §1.469-9(g), including having relied on a qualified tax professional.

NEW DEVELOPMENT: In PLR 202006012, married taxpayers were granted a 120-day extension to make the IRC Sec. 469(c)(7)(A) election to treat all their interests in rental real estate as single rental real estate activity. The taxpayers represented that they were not advised by their professional tax return preparer that the election under IRC Sec. 469(c)(7) was available to them and that they inadvertently filed their joint return for the affected tax year without the statement required under Reg. §1.469-9(g)(3). Taxpayers were found to have acted reasonably and in good faith.

Real estate professionals who do not properly elect to aggregate rental properties as a single activity under IRC Sec. 469(c)(7)(A) would have to materially participate with respect to each of their separate properties to avoid passive treatment on a property-by-property basis.

COURT CASES: In *Shiekh*, the taxpayer who owned and managed several rental properties had to meet material participation requirements under the passive activity loss rules for each rental property because he failed to file an election to treat his rental properties as a single activity. This resulted in deductions for certain losses being disallowed as PALs. (*Anjum Shiekh v. Comm.*, TC Memo 2010-126)

In *Windham*, the taxpayer is a stockbroker who owned 12 rental properties and a 50% interest in a vacant lot in Florida. She managed all aspects of the properties and could prove 901 hours on real estate activities. She was able to meet the 50% and 750-hour rules. She used the loss as a real estate professional to offset her brokerage income.

The taxpayer admitted that she never made the election but argued that it was not required prior to Rev. Proc. 2010-13. The Tax Court found that the taxpayer did not make the grouping election and had to treat each property separately. Despite this, the Court still allowed her to treat the rental activities as nonpassive (*Patricia A. Windham v. Comm.*, TC Memo 2017-68).

Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business [IRC Sec. 469(c)(7)(C)].

COURT CASE: In *Agarwal*, it remained unclear whether a real estate agent qualified for the real estate professional exception even after regulations were issued. Under IRC Sec.469(c)(7), brokerage is listed while agent is not. The Tax Court held that a licensed real estate agent's activity counts for purposes of the Section 469 passive loss exception for qualifying real estate professionals. It stated that whether a taxpayer is characterized as a broker or a salesperson for state law purposes is irrelevant for federal income tax purposes.

The test is whether they were engaged in brokerage as defined by IRC Sec. 469. Consistent with the taxpayer's real estate sales license and pursuant to the contract with the brokerage firm, the taxpayer was engaged in brokerage, selling, exchanging, leasing, or renting real property and solicited listings. Therefore, the taxpayer was engaged in a brokerage trade or business within the meaning of IRC Sec. 469(c)(7)(C) and was allowed to use the real estate professional exception. (*Agarwal v. Comm.*, TC Summary Opinion 2009-29)

Prior year suspended losses do not qualify for total deduction in a year after an individual becomes a qualified real estate professional but may qualify for the $25,000 active participation allowance.

The only reference on Form 1040 to the provisions of the real estate professional is on Schedule E, line 43, which states, "If you were a real estate professional…enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules." Save the election in the year it is made; this appears to be the only way to indicate on the return itself that the taxpayer qualifies as a real estate professional.

Qualifying as a real estate professional doesn't necessarily mean a taxpayer's rental real estate activity is an IRC Sec. 162 trade or business. If the activity isn't a trade or business or the real estate professional doesn't materially participate in the activity, then the rental income will be included in net investment income (NII). The NIIT regulations provide a safe harbor under which rental income and gain of some real estate professionals isn't included in NII. To qualify for the safe harbor, a real estate professional [as defined under IRC Sec. 469(c)(7)(B)], must—

1. Participate in a rental real estate activity for more than 500 hours during the year, or

2. Have participated in the real estate activities for more than 500 hours in any five tax years (whether or not consecutive) during the ten tax years that immediately precede the tax year.

If the taxpayer qualifies for the safe harbor, then gross rental income from that rental activity is deemed to be derived in the ordinary course of business to which the NIIT doesn't apply. In addition, gain or loss resulting from the disposition of property used in that rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business to which the NIIT doesn't apply.

GROUPING ACTIVITIES

An activity can be treated as a separate unit. Alternatively, one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC Sec. 469. Reg. §1.469-4 (Definition of Activity) sets forth the rules for grouping a taxpayer's trade or business activities and rental activities:

1. Whether activities constitute an appropriate economic unit depends upon all relevant facts and circumstances.

2. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities.

3. The following factors, not all of which are necessary for a taxpayer to be able to treat more than one activity as a single activity, are given the greatest weight:

    a. Similarities or differences in types of trades or businesses,

    b. The extent of common control and ownership,

    c. Geographical location, and

    d. Interdependencies between or among the activities (i.e., the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

PLANNING TIP: Effective for tax years beginning after January 25, 2010, Rev. Proc. 2010-13 requires taxpayers to report in writing the original groupings, any addition of a new activity, and regroupings of activities, for purposes of the IRC Sec. 469 PAL rules and Reg. §1.469-4.

EXAMPLE: Treatment of grouped activities

Dolly has a significant ownership interest in a llama ranch and retail yarn store in Cincinnati, OH, and a llama ranch and retail yarn store in Louisville, Kentucky. There may be more than one reasonable method for grouping Dolly's activities. Depending on the relevant facts and circumstances, her businesses may be grouped as (a) a single activity; (b) a ranch activity and a retail yarn activity; (c) a Cincinnati activity and a Louisville activity; or (d) four separate activities.

Note that once Dolly groups these activities into appropriate economic units, she is required to continue using that grouping in subsequent taxable years unless her original grouping was clearly inappropriate, or a material change in the facts and circumstances makes it clearly inappropriate [Reg. §1.469-4(e)]. She would follow Rev. Proc. 2010-13 to report the change by attaching a statement to her income tax return.

Dolly must file a written statement with her original income tax return for the first taxable year in which two or more trade or business activities or rental activities are grouped as a single activity. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity.

The statement must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC Sec. 469. Similar statements must be filed in the event Dolly regroups or adds new members to the grouping. If the original grouping was incorrect, she must also include an explanation as to why the original group was inappropriate or the nature of the material change that made the original grouping clearly inappropriate.

PLANNING TIP: Taxpayers with MAGI exceeding the NIIT thresholds are permitted a one-time "fresh start" regrouping privilege for the first taxable year in which the taxpayer owes NIIT (without regard to the regrouping). It applies to the year of regrouping and all future years and is made under the disclosure requirements of Rev. Proc. 2010-13 [Reg. §1.469-11(b)(3)(iv)].

In addition, the final regulations permit a one-time regrouping on an amended return if the taxpayer was not originally subject to NIIT on the original return and due to a change on the return, is now subject to NIIT [Reg. §1.469-11(b)(3)(iv)(C)].

Restrictions

A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit and—

1. The rental activity is insubstantial in relation to the trade or business activity,

2. The trade or business activity is insubstantial in relation to the rental activity, or

3. Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

EXAMPLE: Restricted grouping of activities

KC and Mo are married and file a joint return. KC is the sole shareholder and material participant in a law firm based in Kansas City, Missouri. Mo is the sole shareholder of a corporation that owns and rents out a building, part of which is leased to the KC's law firm. The law firm and rental company are substantial in relation to each other.

Since KC and Mo file a joint return, they are treated as one taxpayer for purposes of IRC Sec. 469. Consequently, each owner has the same proportionate ownership interest in the rental activity. Accordingly, the law firm and rental company may be grouped together in a single trade or business activity under Reg. §1.469-4(d)(1)(i).

Activities involving the rental of real property and the rental of personal property (other than personal property provided in connection with the real property or real property provided in connection with the personal property) may not be treated as a single activity [Reg. §1.469-4(d)(2)].

Disclosure and consistency requirements. Reg. §1.469-4(e)(1) provides that once a taxpayer has grouped activities, regrouping or grouping changes are not allowed in subsequent taxable years. If it is determined that a taxpayer's original grouping was clearly inappropriate, or a material change in the facts and circumstances has occurred, the taxpayer must regroup the activities and must comply with disclosure requirements that the Commissioner may prescribe [Reg. §1.469-4(e)(2)].

In addition, the Commissioner may regroup a taxpayer's activities if any of the groupings are determined not to be an appropriate economic unit and a principal purpose of the taxpayer's grouping is to circumvent the underlying purposes of IRC Sec. 469. If two undertakings are each part of a single activity, the taxpayer need only establish material participation for one. If there are two separate activities, the taxpayer must establish material participation separately for each.

COURT CASE: In *Hardy*, the Tax Court made several holdings with respect to a surgeon who operated his practice as a sole practitioner and also held a minority interest in a limited liability company (LLC) that ran a surgical center at which he sometimes performed surgery. Among those holdings was the conclusion that IRS could not group his income from the LLC with his sole practitioner income for purposes of the passive activity loss (PAL) rules.

The Court found that Hardy did not have a principal purpose of circumventing the underlying purposes of IRC Sec. 469 when they treated the two activities as separate. (*Hardy v. Comm.*, TC Memo 2017-16)

SUSPENDED LOSSES AND DISPOSITIONS

Passive activity losses that cannot be claimed on the current return are suspended and carried forward to a year when—

1. There is net passive income,
2. The $25,000 rental real estate offset is available, and the suspended losses are from qualifying active rental real estate, or
3. The activity is disposed of in a qualifying disposition.

Income from the sale or other disposition of a passive activity is passive income. It may be used to offset current and suspended losses of other passive activities.

NOTE: Long-term capital gain income from the disposition of a passive activity frees up ordinary passive losses. Both suspended losses and resulting gains or losses on disposition will be included for NII in the year recognized, subject to capital loss limitations.

Suspended losses are freed up upon a complete disposition of a passive activity. However, if two or more activities are treated as a single activity, the taxpayer must dispose of all, or substantially all, of the activities in the group before the activity is considered disposed of and suspended losses are freed up.

Current and carryforward passive losses are fully deductible on disposition of a passive activity if the disposition is—

1. of an entire interest,
2. a fully taxable transaction, and
3. not to a related party.

The following are not fully taxable transactions, and therefore do not trigger release of current and suspended losses:

1. An exchange in which there is no recognition of gain,
2. A sale to a related party or conversion to personal use,
3. A disposition by gift that causes the basis of the transferred interest to be increased by the amount of such losses for which a deduction has not been allowed [IRC Sec. 469(j)(6)(A)],
4. A transfer incident to a divorce that is treated as a gift and the losses of the donor spouse are added to basis,
5. The death of an owner of a passive activity creates a deduction on the final return, if the current and suspended loss of the activity exceeds the step-up in basis [IRC Sec. 469(g)(2)], or
6. Transfer to a corporation, partnership, or LLC.

If a taxpayer becomes a material participant, or converts rental property to a personal residence, suspended losses remain suspended until the activity is converted back to a passive activity or is disposed of in a qualifying disposition.

Qualified rental real estate losses that have been suspended may be deductible in a subsequent year if any part of the $25,000 offset is available.

Disposition of a passive activity on the installment basis provides that current and suspended losses may only be deducted in the same proportion of such losses for each taxable year which bears the same ratio to all such losses as the gain recognized on such sale during such taxable year bears to the gross profit from such sale (realized or to be realized when payment is completed) [IRC Sec. 469(g)(3)].

Net income from a disposition of substantially appreciated property will be treated as not from a passive activity unless the property was used in a passive activity for either 20% of the taxpayer's holding period or the entire two-year period ending on the date of disposition [Reg. §1.469-2(c)(2)(iii)(A)]. Substantial appreciation occurs if FMV exceeds 120% of the adjusted basis. This is an exception to the general rule that gain from a disposition of property used in a passive activity in the year of disposition is passive. Without this exception, taxpayers could transfer substantially appreciated property to a passive activity just before disposition, thus converting nonpassive gain into passive gain.

Casualty losses suffered by a passive activity are not treated as a passive deduction and are allowed in full in the year sustained. Similarly, related insurance reimbursements are not treated as passive income.

NET INVESTMENT INCOME TAX (NIIT) RELATED TO PASSIVE ACTIVITY

Net investment income (NII) for the NIIT includes income and gains less losses and allocable deductions from passive business activities, but not trades or businesses in which the taxpayer materially participates (except the business of trading in financial instruments or commodities) [IRC Sec. 1411(c)].

Generally, the NIIT regulations state that a passive business activity is a trade or business within the meaning of IRC Sec. 162 that is also passive within the meaning of IRC Sec. 469 and related regulations (i.e., the taxpayer does not materially participate).

EXAMPLE: Determining NII status

Sophia is a partner in RFC, a retail furniture company. RFC's income is derived from the sale of sofas. Sophia does not materially participate in RFC and receives a share of profits totaling $200,000. The activity qualifies as Section 162 business activity and is treated as a nonpassive business activity at the entity level. Since Sophia does not materially participate, her income is considered passive and is subject to NIIT.

NIIT applies to gains recognized on the sale of passive income property. Since gains are reported separately from suspended losses, there is the potential to pay NIIT on the gain even though losses are in excess of any gain recognized. Recognized passive losses will reduce adjusted gross income (AGI) for NIIT threshold purposes.

Taxpayers with suspended passive losses should consider purchasing or participating in investments that generate passive income rather than portfolio income. Note that regardless of whether income from a publicly traded partnership is characterized as income or gain (e.g., depending on whether or not it represents a distribution of earnings and profits under IRC Sec. 301), that income is treated as portfolio income for purposes of the passive activity loss rules [Notice 88-75].

Generally, an interest in a partnership or S corporation is considered held for investment. Thus, gain or loss from disposition would be a passive business activity and is subject to NIIT [IRC Sec. 1411(c)(1)(A)(iii) and Reg. §1.1411-4(d)(4)(i)(B)(1)]. However, gain or loss on disposition of a nonpassive business activity may not be subject to NIIT [IRC Sec. 1411(c)].

To qualify, the partnership or S corporation is engaged in one or more businesses under IRC Sec. 162 (determined at the entity level) and the pass-through income, gains, and losses are nonpassive (determined at the owner level) [Regs. 1.1411-4(b)(2) and (d)(4)(i)(B)(3)].

Special rules are used for dispositions of interests held in nonpassive business activities to separate the passive and nonpassive. There is an optional simplified reporting method and a complicated regular method. To use either method, the transferor partner or shareholder must make a Section 1411(c)(4) disposition. To be eligible, the partnership or S corporation must be directly engaged in one or more Section 162 businesses, or indirectly engaged in them through a pass-through entity, and the transferor partner or shareholder materially participated in at least one of the Section 162 businesses [Prop. Reg. §1.1411-7(a)(3)].

The optional simplified reporting method can be used if the regular tax or gain is $250,000 or less, or the sum of the transferor's shares of pass-through items (losses and deductions are treated as positive numbers) subject to NIIT is 5% or less of total pass-through items and the total regular tax gain or loss on disposition is $5 million or less [Prop. Reg. §1.1411-7(c)(2)].

EXAMPLE: Determining method of calculating NIIT

Sweeny Todd owns a 25% interest in Barber Shop, LLC (BSL) in which he materially participates. He sells the interest for a regular tax gain of $200,000. Most of BSL's assets are from an Section 162 business. During the Section 1411 holding period, Sweeny is allocated $25,000 of interest and dividends from working capital investments (subject to NIIT) and $475,000 of BSL net income from business activities.

Sweeny qualifies for the shortcut method since his gain is under the $250,000 limit ($200,000).

Sweeny calculates the NIIT as follows: [$25,000 (NIIT pass-through income) ÷ $500,000 (total pass-through income) = 5%] × $200,000 (regular tax gain) = $10,000 subject to NIIT.

The regular method is complex and involves calculating gains or losses that would result from a hypothetical sale of all the partnership or S corporation's Section 1411 property at FMV. (See Prop. Reg. §1.1411-7(b) for details.)

SELF-CHARGED INTEREST INCOME

Under Reg §1.469-7, self-charged interest income derived from a passive activity may be treated as passive activity gross income, despite the rule prohibiting interest income from being treated as income from a passive activity. This means that the self-charged interest income recharacterized as passive may be offset by passive activity losses and credits. Interest on loans between partnerships and their partners, or S corporations and their shareholders, is considered self-charged.

Interest income may be wholly or partially recharacterized as passive activity gross income, which can be offset by passive activity losses and credits if—

1. The interest income is from a loan or lending transaction made by the taxpayer to a passthrough entity (i.e., a partnership or an S corporation) in which the taxpayer owns a direct or indirect interest, and the deductions passed through to the taxpayer for the entity's payment of that interest include passive activity deductions.

2. Interest income is from a loan or lending transaction made to the taxpayer by a passthrough entity in which the taxpayer owns a direct or indirect interest, and the taxpayer's deductions for the interest charged by the entity include passive activity deductions; or

3. The interest income is from a loan or lending transaction between two identically owned passthrough entities in which the taxpayer has a direct or indirect interest, and the deductions passed through to the taxpayer for the debtor-entity's payment of interest to the creditor-entity include passive activity deductions.

EXAMPLE: Treatment of self-charged interest

Starr lent $10,000 to an S corporation in which she is the sole shareholder. The S corporation, which was engaged in a passive (rental) activity with respect to Starr, paid her $1,000 interest. The corporation's $1,000 interest deduction passes through to her as interest income. Starr qualifies for passive treatment for her interest income, so she can use passive losses from the S corporation to offset her $1,000 of interest income.

Items from non-lending transactions cannot be offset under the self-charged rules [Reg. §1.469-11(c)(1)(iii)(2)].

COURT CASE: The taxpayers in *Hillman* received management fees from a passive activity in which they owned an interest. The activity incurred a loss, and the taxpayers argued that the management fees should be treated as self-charged items, so that they could use the passive loss to offset their admittedly nonpassive income. In making this claim, the taxpayers contended that the proposed regulations should apply to self-charged items other than interest. The IRS was successful in arguing that the taxpayers could not use the loss to offset their nonpassive management fee income. (*Hillman v. Comm.*, 88 AFTR 2d 2001-5292)

The final regulations clarify that the self-charged rules apply to interest on loans from partners and S corporation shareholders, OID, unstated interest, and foregone interest.

The applicable percentage of a taxpayer's interest income from an entity is treated as passive activity gross income and the applicable percentage of the interest expense allocable to that interest income is treated as a passive activity deduction from the activity. The applicable percentage is obtained by—

1. Dividing the taxpayer's share of the borrowing entity's self-charged interest deductions that were treated as passive activity deductions by the greater of—
    a. The taxpayer's share of the borrowing entity's self-charged interest deductions (whether or not treated as passive activity deductions) or
    b. The taxpayer's income for the tax year from interest charged to the borrowing entity.

EXAMPLE: Determining applicable percentage of interest income

Sleepy and Grumpy each own 50% of Passive Partnership (PP), which was engaged in a rental activity. PP borrowed $10,000 from Sleepy and $20,000 from Grumpy and paid $500 and $1,000 of interest to each respectively. Because PP was a 50/50 partnership, each was allocated $750 of interest deductions. Sleepy's applicable percentage is 100% ($750 divided by the greater of $750 or $500), whereas Grumpy's applicable percentage is 75% ($750 divided by the greater of $750 or $1,000). Sleepy was entitled to treat all $500 of his interest income from PP as passive income, but Grumpy could treat only 75% of his interest income from PP, or $750, as passive income and will have $250 of interest income treated as portfolio income.

Loans between brother-sister entities are eligible for the self-charged interest rules only if the two entities have identical ownership. No relief is available for an individual who receives portfolio interest income that is economically related to passive interest deductions from another entity that is not identically owned.

EXAMPLE: Loan between sibling entities

Donny owns 99% of partnership P1 and 98% of P2, which are both engaged in a passive activity. The remaining interest in each partnership is owned by an unrelated person, Marie. P1 lends $1,000 to P2 at 10%. Donny's $98 interest deduction from P2 is economically related to his $99 of interest income from P1. The regulations, however, do not provide any relief in this situation, so that Donny would be required to report $99 of portfolio interest income and a $98 passive loss.

The recharacterization rules for self-charged interest do not apply with respect to any taxpayer's interest in a pass-through entity for a tax year, if the pass-through entity makes an election that applies to the entity tax year [Reg. §1.469-7(g)]. A partnership or S corporation might want to make this election when the partners or shareholders can benefit from using their interest income as portfolio income rather than as passive income. This might occur when partners or shareholders have otherwise nondeductible excess investment interest expense to offset against the portfolio income, but not passive losses to offset interest treated as passive income.

For NIIT purposes, self-charged interest from a nonpassive activity owned by the taxpayer is treated as derived from a nonpassive activity in certain situations [Reg. §1.1411-4(g)(5)].

MIXED-USE PROPERTY AND RENTING PART OF A HOME

Counting Personal and Rental Days

Personal use includes days the residence is used or rented to anyone at less than at FMV [IRC Sec. 280A(d)(2)(C)]. Personal use by other owners (or members of their family) of the property is attributed to the taxpayer [IRC Sec. 280A(d)(2)(A)].

Rental days to a family member (e.g., brother, sister, spouse, ancestor, lineal descendent) are considered personal use unless the taxpayer can establish that both—

1. A fair market rental rate was received, and

2. The dwelling unit was used as the family member's principal residence.

Rental days under a reciprocal arrangement that allows a taxpayer to use another dwelling unit are considered personal use, even if the taxpayer pays rent for the use of the other dwelling unit [IRC Sec. 280A(d)(2)(B)].

Days a taxpayer spends repairing and maintaining property on a substantially full-time basis are not counted as days of personal use if [Prop. Reg. §1.280A-1(e)(4)]—

1. Substantially full-time (determined daily) means work is done on the dwelling unit for the lesser of eight hours or two-thirds of the time the individual is present on the premises; and

2. All individuals on the property who are capable of working need to do work on the dwelling unit on a substantially full-time basis. Use by other individuals or family members (e.g., children) who are not capable of such work is disregarded during a period of repair and maintenance [Twohey, TC Memo 1993-547].

Tax reporting of the rental of a taxpayer's residence or vacation home depends on how many days the property is used for rental purposes as opposed to personal purposes. A residence or dwelling for the purpose of IRC Sec. 280A is defined as a dwelling unit and includes a house, apartment, condominium, mobile home, boat, or similar property. Residences used personally by the taxpayer generally fall into one of three categories when determining their tax treatment [IRC Sec. 280A]:

1. *Personal residence with very limited rental use.* A residence that is rented for fewer than 15 days during the year.

2. *Vacation home with both rental and personal use.* Property with (a) personal use that exceeds the greater of 14 days or 10% of rental days and (b) rental use that exceeds 14 days.

3. *Rental property with very limited personal use.* Property rented during the year and personal use that does not exceed the greater of 14 days or 10% of rental days.

Personal Residence with Limited Rental Use

A residence that meets the definition of a dwelling unit and is rented for fewer than 15 days during a year is treated as personal use property. This one-of-a-kind tax break can be a windfall for those who own properties in prime vacation spots or in other sought-after areas (e.g., one near a prime sporting event) where even a few rental days can provide substantial income.

No rental income is reported. Offsetting rental deductions are not reported either [IRC Sec. 280A(g)].

PLANNING TIP: Renting out a home on Airbnb (an online marketplace) is a popular way to earn extra income. IRC Sec. 280A will determine the tax implications of the activity's net income (or loss).

EXAMPLE: Determining rental use amount of personal residence

Jack owns a home in Columbus, OH, on the 18th hole of a golf course where a popular tournament is played every May. Every year during the tournament, he takes his annual vacation and rents out his home the week he is gone. Jack receives $30,000 for the week-long rental of his home. Because the home is rented for fewer than 15 days during the year, the rental income is not taxable, and rental expenses he incurs are nondeductible. Further, Jack is still allowed to fully deduct the qualified residential interest expense and real estate taxes on his Schedule A. The result is the same whether the home is his primary residence or a vacation home.

Vacation Home with Both Rental and Personal Use

A home that meets the definition of a *dwelling unit* and (a) personal use exceeds the greater of 14 days or 10% of rental days and (b) rental use exceeds 14 days. Although the property is a residence, the owner still must treat the rental portion separately from the personal portion.

Rental income is fully reported on Schedule E and can be offset by qualified rent-related deductions. However, rental deductions cannot exceed rental income [IRC Sec. 280A(c)(5)]. The following deductions are permitted in the following order [Prop. Reg. §1.280A-3(d)]:

1. Qualified residential interest, property taxes, casualty losses, and rental expenses not attributable to operating or maintaining the dwelling (e.g., expenditures to obtain tenants, such as commissions and advertising).

2. Operating expenses (including nonqualified residential interest), except depreciation.

3. Depreciation and other basis adjustments.

Excess operating expenses and depreciation expenses are separately carried forward and can be used to offset rental income in future years. Since rental deductions are effectively restricted by IRC Sec.

280A(c)(5), the taxpayer doesn't have to worry about the passive loss rules for that year. They specifically do not apply in this situation [IRC Sec. 469(j)(10)].

CAUTION: Any unused carryover losses disappear once a property is sold.

Personal portions are treated as follows:

1. The owner deducts the qualified mortgage interest and real estate taxes allocable to personal use of the home on Schedule A (if otherwise deductible).

PLANNING TIP: The dwelling unit must be a qualified residence for purposes of the mortgage interest deduction under IRC Sec. 163(h)(4)(A)(i).

2. There are two methods for allocating qualified mortgage interest and real estate taxes between Schedule A and E:

    a. The IRS method apportions all expenses between rental and personal use based on the number of days used for each purpose [Prop. Reg. Sec. 1.280A-3(d)(3)(iii)].

    b. The Tax Court method permits the taxpayer to allocate mortgage interest and real estate taxes based on the ratio of actual rental days to total calendar days [Bolton, 51 AFTR 2d 83-305 (9th Cir., 1982)].

PLANNING TIP: The Tax Court method allocates a smaller amount of interest and taxes to Schedule E, where the losses are often limited, and allows greater potential deductions to Schedule A.

Rental Property with Limited Personal Use

Rental property with very limited personal use is property rented during the year with personal use that *does not* exceed the greater of 14 days or 10% of rental days.

Rental income is fully reported on Schedule E and can be offset by qualified allocable rent-related deductions as previously noted under mixed-use property. The rental property income and deductions are treated as passive in nature. Thus, the taxpayer's loss (if any) is restricted by the passive loss rules unless the owner qualifies under the real estate professional exception. If deductions allocable to the rental portion exceed rental income, the loss generally can only offset other passive income until the property is disposed of.

PLANNING TIP: Some dwelling units have an average period of customer use that is seven days or less, which means that the activity is not a rental activity (thus, no $25,000 exception). Therefore, the material participation test must be met to deduct any losses (*Toups v. Comm.*, TC Memo 1993-359; *Chapin v. Comm.*, TC Memo 1996-56; and *Mordkin v. Comm.*, TC Memo 1996-187).

Most Airbnb rentals would fall into this category and are not considered rentals. Such rentals meeting the material participation test would avoid the passive activity loss limitation rules.

Personal portions of expenses are not deductible except real estate taxes on Schedule A (if otherwise deductible). The Schedule A mortgage interest deduction is lost (for the nonrental portion) because the property does not qualify as a residence.

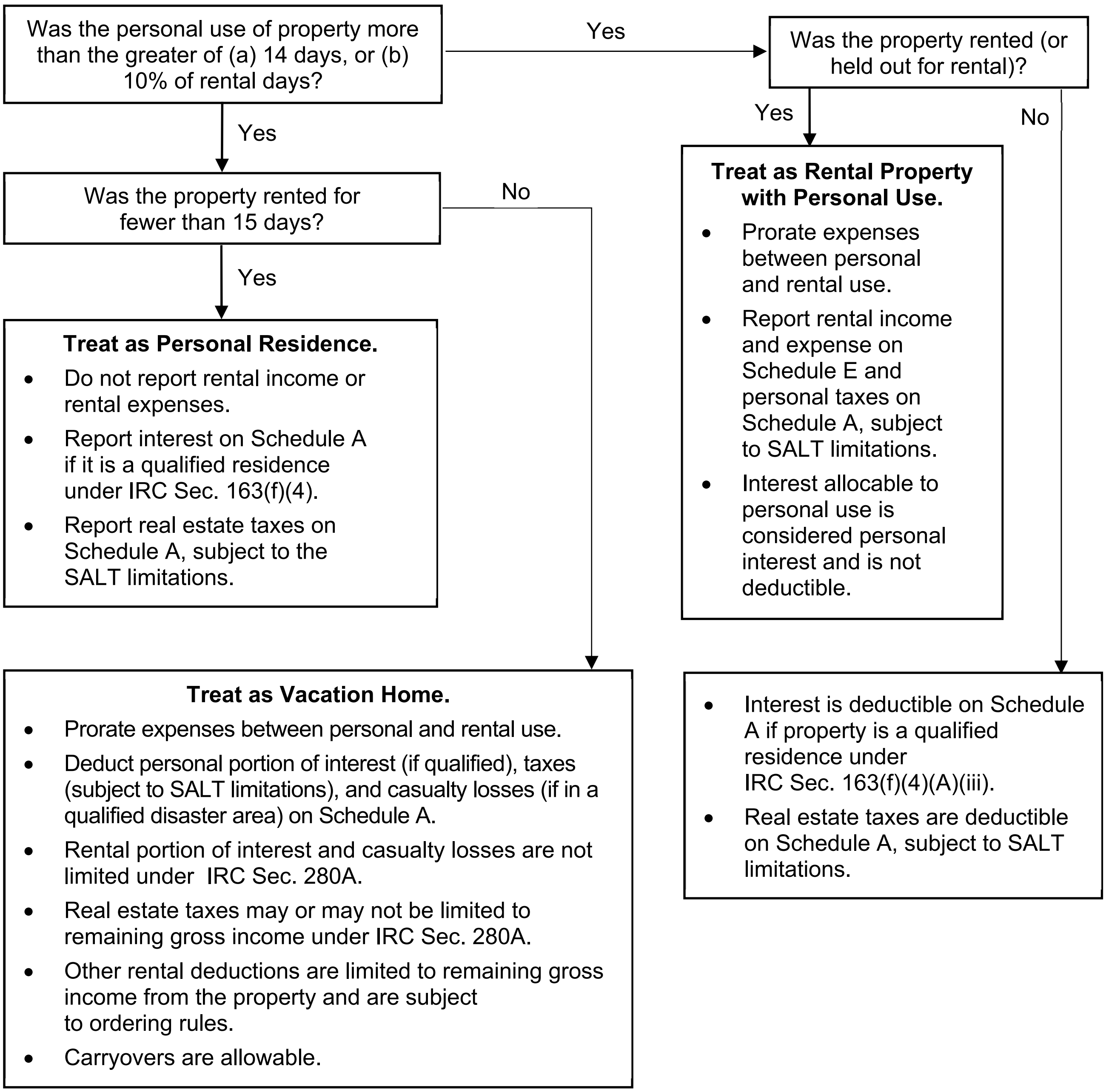
When a taxpayer rents a portion of the dwelling unit used as his residence, the rules for deducting rental expenses generally depend on whether the property constitutes a single dwelling unit or multiple dwelling units. For example, if a taxpayer owns a duplex, with half used exclusively as a personal residence and the other half used exclusively for rental purposes (and assuming that each half has a separate entrance and no common-use areas), the IRC Sec. 280A residential rental limitations on deductions do not apply to the rental unit [Prop. Reg. §1.280A-1(c)(1)].

Conversely, a residence with mixed personal and rental use faces the restrictions of IRC Sec. 280A (as discussed above). Common areas, such as a family room, are considered personal use (*Anderson v. Comm.*, TC Memo 2006-33). Separate structures with separate entrances on the property are considered rentals if not also used personally (*Morcos v. Comm.*, TC Summary Opinion 2001-114).

EXAMPLE: Treatment of residence with mixed rental and personal use

Sherry rents out a portion of her 2,000 sq. ft. home to a tenant. The tenant has his own bedroom and bathroom, totaling 200 sq. ft., but he shares the living room, dining room, and kitchen with Sherry. Sherry can allocate 10% of the expenses to rental use (200 ÷ 2,000). If she rented out a detached dwelling behind her home, she could treat that building as a separate 100% rental property.

Flowchart to Determine Tax Treatment of Residence with Mixed Rental and Personal Use



WHERE TO GO FOR MORE INFORMATION

- IRS Passive Activity Loss Audit Technique Guide (ATG)
- IRS Pub. 925, *Passive Activity and At-Risk Rules*
- IRS Pub. 527, *Residential Rental Property (Including Rental of Vacation Homes)*
- IRS Gig Economy Tax Center at **www.irs.gov/businesses/small-businesses-self-employed/sharing-economy-tax-center**

CHAPTER 35: PASS-THROUGH ENTITIES

Learning Objectives

Completion of this chapter will enable participants to—

- Summarize Schedule K-1 reporting for Forms 1065, 1120S and 1041.
- Explain limitations on pass-through losses, including outside and at-risk basis, and passive activity loss limitations.
- Summarize regulations regarding S corporation bona fide indebtedness.

WHAT'S NEW

The IRS has updated Schedule K-1 for Form 1120-S to include the number of shares a shareholder held at the beginning and end of the year and the amount of loans from shareholder at the beginning and end of the year.

SCHEDULE K-1 OVERVIEW

Generally, a partnership or S corporation is not taxed at the entity level. Rather, it passes through items of income, loss, deduction, or credit to its owners who report those items on their returns.

Pass-through items are reported in total on Form 1065 or Form 1120-S Schedule K, and each owner's pro rata share of the pass-through items is reported on that owner's Schedule K-1. For example, Schedule K includes partnership trade or business ordinary income (from Form 1065, Page 1, line 22) on line 1, and a portion of this amount is then reported on line 1 of each of the partners' Schedules K-1.

Schedule K and the corresponding lines of Schedule K-1 are devoted to information necessary for the owners to make tax computations with respect to both ordinary income or loss (line 1) and all separately stated items (e.g., rental activity income or loss, capital gains, investment interest expense) that may require special handling at the owner level. Additional lines are devoted to providing information about tax credits, self-employment (SE) income, and alternative minimum tax (AMT), with respect to partnership or S corporation items.

Schedule K-1 can be confusing because it includes regular tax income, gain, loss, and deduction items, along with various other amounts needed to compute limitations on deductions, a partner's AMT, a partner's basis in his partnership interest, etc. Reporting an individual taxpayer's share of income, deductions, losses, and credits from pass-through entities is a complex area of tax law. Factors such as at-risk limitations, basis limitations, passive loss rules, and loan repayments must be considered in reporting Schedule K-1 items.

Critical information is often disclosed as supplemental information to Schedule K-1 that requires additional examination by practitioners. According to Rev. Proc. 2012-17, a partnership can furnish Schedule K-1 in electronic format instead of on paper. By meeting requirements of Rev. Proc. 2012-17, a partnership will be treated as furnishing the Schedule K-1 in a timely manner.

For many years, the IRS has conducted a Schedule K-1 matching program for pass-through returns. Pass-through items reported on Schedule K-1 are matched to individual tax returns filed by the owners. In addition, examiners screen returns manually for such items as passive losses and issue a notice if they cannot determine where information is presented on the owner's return. Significant differences or a failure to respond to a request for information can lead to a notice or other correspondence from the IRS.

Information Release 2005-34 offered suggestions for avoiding a mismatch notice relating to the reporting of information on flow-through Schedule K-1. These suggestions include the following:

Practitioners should use the codes on page 2 of Schedule K-1 to identify items on the Schedule K-1.

Practitioners should make sure the member's correct TIN is reported on the Schedule K-1. The Information Release clarified that the appropriate recipient of the Schedule K-1 for a disregarded entity is the entity's owner and that the owner's TIN should be used.

1. Practitioners should correctly identify an amended Schedule K-1 by checking the appropriate box.

2. Pass-through owners should report income in the proper location on their Form 1040 (or other return) according to the instructions to Schedule K-1.

3. Pass-through owners should not net or combine income against separately stated losses or expenses. Ordinary business income should be reported separately from other related deductions, such as unreimbursed partnership expenses or Section 179 expenses.

4. Pass-through owners should report prior-year losses that become deductible under the at-risk or basis limitation provisions on a separate line from current-year amounts.

5. Pass-through owners who have not received a Schedule K-1 by the time they file their individual tax return and file the return with an estimated amount of partnership income should file Form 8082 (Notice of Inconsistent Treatment or Amended Return) with Form 1040.

BBA partnerships (i.e., those partnerships that fall under the centralized partnership audit regime) have a consistency reporting requirement. Failure to report partnership items consistently with the Schedule K-1 without proper disclosure will be treated as a math error by IRS. The disclosure for inconsistent treatment is also made on the Form 8082.

PLANNING TIP: According to AICPA's SSTS (Statement on Standards for Tax Services) No. 4, Use of Estimates, unless prohibited by statute or by rule, a member may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer's estimates should be presented in a manner that does not imply greater accuracy than exists. The authors recommend using rounded numbers to reflect the estimated amounts.

There can be several different activities on one Schedule K-1. Schedules K-1 can also originate from brokerage accounts that invest in publicly traded partnerships (PTP) or master limited partnerships (MLP).

RECENT DEVELOPMENT: A taxpayer is entitled to a pass-through deduction based on the taxpayer's qualified business income (QBI) for the tax year (see Chapter 40 for a comprehensive discussion of the deduction).

The qualified business income deduction for noncorporate taxpayers is applied to partnerships and S corporations at the partner or shareholder level [IRC Sec. 199A(f)(1)(A)(i)]. Thus, each partner or shareholder must take into account his allocable share of each qualified item of income, gain, deduction, and loss.

A partner's or shareholder's allocable share of W-2 wages is determined in the same manner as the partner's or shareholder's allocable share of wage expenses. A partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition (UBIA) of qualified property is determined in accordance with Reg. §1.199A-2. In the case of an S corporation, each shareholder's share of the UBIA of qualified property is the share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation. In the case of a partnership, UBIA is allocated in accordance with how the partnership would allocate depreciation under Reg. §1.70-1(b)(2)(iv)(g) on the last day of the taxable year.

Note that as the income threshold limitation for determining whether a taxpayer can take the business income deduction is determined at the partner or S corporation shareholder level, some partners and shareholders may be eligible to take the deduction while others in the same partnership or S corporation may not.

Partnerships may have the flexibility to cause specific partners to be allocated W-2 wages and unadjusted basis, by making special allocations of wage expenses and depreciation deductions.

PARTNERSHIPS

Publicly Traded and Master Limited Partnerships

A *publicly traded partnership* (PTP) is any partnership if interests in such partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof). This does not include a publicly traded partnership treated as a corporation under IRC Sec. 7704 of the Internal Revenue Code. A PTP combines the tax benefits of a limited partnership (LP) with the liquidity of regularly traded securities on an established securities market.

A *master limited partnership* (MLP) is a limited partnership managed by two or more general partners. It is capitalized by limited partners who provide capital but have no management role in the partnership.

The terms *master limited partnership* and *publicly traded partnership* are often used interchangeably. However, there are some minor differences (for example, not all PTPs are MLPs, and not all MLPs are PTPs because some are not publicly traded).

PLANNING TIP: Check out www.taxpackagesupport.com, the gateway for tax information and support for investments in publicly traded partnerships. A practitioner can sign up to be notified when Schedules K-1 become available.

At least 90% of a PTP's gross income must be comprised of interest, dividends, real property rents (including gain from the disposition of real property), income and gains from commodities (or futures, forwards, and options), and income or gain from mineral or certain natural resource activities.

Passive activity losses (PALs) from a PTP may be used only to offset income or gain from the same PTP. The $25,000 (maximum) active participation allowance for rental real estate activities does not apply to PALs arising from a PTP.

Numerous issues need to be addressed on a taxpayer's return, such as:

1. Increased cost and complexity of the return. Taxpayers have been investing in PTPs because of their touted high dividend rate of return. Unfortunately, many publications and advisors do not understand the difference between "partnership distributions" and "dividends." Further, investors truly do not understand the difference between corporation and partnership tax and reporting. These partnerships often provide extensive federal and multistate Schedules K-1 that greatly increase the complexity (and resulting cost) of the return preparation.

2. Possible Section 751 income. When a PTP interest is sold, the partner is required to report the ordinary income (Section 751 or hot asset ordinary income) component of the sale.

3. Depreciation required to be recaptured. Schedules K-1 should be retained for all years where possible.

4. Suspended PALs may be allowable upon disposition. This will have no effect on basis, as basis will be reduced each year for suspended losses. The taxpayer can take the suspended losses as ordinary deductions in the year of sale.

5. AMT basis is likely to be different than regular tax basis. Practitioners should exercise care that the required adjustments are made.

6. Section 754 disclosure may be required. Reporting and basis variances between a taxpayer and a partnership could trigger this disclosure requirement.

A brokerage firm typically reports the original purchase price in the cost box on Form 1099-B—this is incorrect!

PLANNING TIP: The original purchase price must be adjusted for all PTP flow-through items that affect basis. Use of basis schedules in tax preparation software or the worksheets accompanying Schedule K-1 will provide the basis when an interest is sold.

RECENT DEVELOPMENT: A taxpayer is entitled to a pass-through deduction based on qualified business income (QBI) (see Chapter 40 for a comprehensive discussion of the deduction).

A taxpayer's combined QBI amount for a tax year is equal to the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer [IRC Sec. 199A(b)(1)(A)], plus 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the tax year [IRC Sec. 199A(b)(1)(B)].

For this purpose, qualified PTP income for any qualified trade or business of the taxpayer is the sum of—

- The net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction and loss (determined after excluding reasonable compensation, guaranteed payments and other payments for services) from an Section 7704 publicly traded partnership that is not treated as a corporation for tax purposes; and

- Any gain recognized by the taxpayer upon the disposition of its interest in such a partnership to the extent that the gain is treated as amount realized from a sale or exchange of property other than a capital asset under IRC Sec. 751(a).

Partner's Basis for Claiming Losses

Losses passed through from partnerships and LLCs (taxed as partnerships) are subject to several limitations. The taxpayer has the burden of proof for these items.

All items of income, deduction, gain, and loss retain their character when passed through to a partner or LLC member.

To determine the deductible amount of any losses reported on Schedule K-1, the practitioner should perform the following tasks in the following order:

1. Compute the outside basis of the partnership interest.
2. Compute amount at-risk under IRC Sec. 465.
3. Compute passive activity limitations under IRC Sec. 469.
4. Consider other loss limitation rules, depending upon the loss being passed through:
    a. Net operating loss,
    b. Net capital loss,
    c. Net IRC Sec. 1231 loss, and
    d. Hobby loss rules of IRC Sec. 183 (these rules apply to all entities, not just sole proprietorships)

Partner's Outside Basis

The preparer of a partner's (member's) personal tax return should take the following steps to calculate outside basis (simplified method):

1. Begin with the partner's (member's) original cost basis (or beginning outside basis), plus
2. Basis of additional assets contributed, plus
3. Share of income (taxable and tax-exempt), plus
4. Increase in partner's (member's) share of liabilities (all debt), minus
5. Basis of assets distributed to partner (member), minus
6. Decreases in year-end liabilities (all debt), minus
7. Share of losses and deductions (deductible or not), equals
8. Partner's outside basis at year-end.

RECENT DEVELOPMENT: For tax years beginning after December 31, 2017, a partner's distributive share of a partnership's charitable contributions and foreign taxes is considered in determining the amount of the partner's loss.

PLANNING TIP: See the detailed Partner's Outside Basis Calculation worksheet in *PPC's 1065 Deskbook*.

Partner's Share of Liabilities and IRC Sec. 752

An increase in a partner's share of partnership liabilities is treated as a hypothetical contribution of cash by the partner to the partnership. This results in an increase in basis [IRC Sec. 752(a)].

A decrease in a partner's share of partnership liabilities is treated as a hypothetical distribution of cash to the partner from the partnership [IRC Sec. 752(b)]. This results in a decrease in basis. If a deemed distribution exceeds the partner's basis, the excess is capital gain. This gain is often referred to as phantom gain, because the partner must recognize taxable income without receiving a distribution of cash or property.

There are three general categories of debt that may be allocated among partners for outside basis purposes: resource debt, nonrecourse debt, and qualified nonrecourse debt (discussed later in the chapter).

Definitions [Reg. §§1.752-1(a)(1) and (a)(2)]

Recourse Liability

Under Reg. §1.752-1(a)(1), a partnership liability is deemed a recourse liability to the extent any partner bears the economic risk of loss with respect to the liability. This economic risk of loss is present only if any partner (whether in his capacity as a partner or otherwise) or any person related to a partner (i.e., a partner affiliate) would be obligated to make a payment to the creditor or a partnership contribution upon a constructive liquidation of the partnership under certain hypothetical circumstances. This hypothetical no value liquidation assumes all partnership assets (including cash) are worthless.

NOTE: For purposes of allocating partnership recourse liabilities under the IRC Sec. 752 rules, the regulations require the evaluation of payment obligations that may exist (1) under the partnership agreement, (2) under applicable state law, and (3) under any other agreements (loan agreements, guarantees, and so forth). Also, in determining who is ultimately liable for a partnership recourse liability, a partner's right to receive reimbursements from other partners (if any) must be considered (for example, a subrogation right or a right to contribution from other partners).

Nonrecourse Liability

A partnership liability (or a portion of a liability) for which no partner bears the economic risk of loss [Reg. §1.752-1(a)(2)]. Only the creditor bears the economic risk of loss with respect to a true nonrecourse liability. If a partner is unable to deduct losses from a partnership because of insufficient outside basis, the loss is limited (partially or totally) and the at-risk and PAL restrictions are academic. (Partners' debt allocations are covered in more detail in Gear Up's *Business Entities* course.)

Partner's At-Risk Basis (IRC Sec. 465)

The at-risk rules limit a partner's deductible loss to the actual risk of loss. Even if a partner has enough outside basis in the partnership interest to absorb losses, the partner may not have adequate amounts at-risk. The at-risk rules of IRC Sec 465 generally apply to all activities.

The amount at-risk (simplified method) is equal to—

1. The amount of cash and adjusted basis of other property contributed to an activity by the taxpayer, plus

2. Amounts borrowed for use in the activity for which the taxpayer is personally liable for repayment of the debt, plus

3. Amounts borrowed for use in the activity, to the extent of the FMV of the individual's property pledged as security (other than property used in the activity), plus

4. The taxpayer's share of qualified nonrecourse financing.

Although nonrecourse loans secured by property used in an activity generally are not considered for at-risk purposes, a special exception applies for real estate. A taxpayer holding real property is considered at risk for his share of qualified nonrecourse financing secured by real property used in the activity [IRC Sec. 465(b)(6); Reg. §1.465-27(a)]. The debt must be secured only by the real property; however, property incidental to the activity and other property if less than 10% of the FMV of all property securing the debt is disregarded [Reg. §1.465-27(b)(2)].

Qualified nonrecourse financing is any financing that is [IRC Sec. 465(b)(6)(B)]:

1. Borrowed for the holding of real property,

2. Borrowed from or guaranteed by a federal, state, or local governmental entity, or borrowed from a person or entity regularly engaged in the business of lending money (e.g., a bank or savings and loan), other than a person related to the taxpayer, a person or entity from which the taxpayer acquired the property, a lender that has an interest in the activity other than that of a creditor, a person who receives a fee from the taxpayer's investment, or someone related to any such person;

3. Debt for which, except as provided in regulations, no one is personally liable for repayment; and

> **NOTE:** After the last recession it is just as likely that a real estate loan will be recourse and not qualified recourse financing. It is more a matter of presentation on the Schedule K-1, because both give a taxpayer at-risk basis.

4. Is not convertible to equity.

There is interplay between the amount at-risk and the computation of a partner's outside basis. A partner's outside basis is increased by nonrecourse debt, but a partner's amount at-risk is not increased by nonrecourse debt unless the debt is qualified nonrecourse financing. The deductible loss from an activity is limited to the lesser of a partner's outside basis in a partnership or the amount at-risk. The amount at-risk in an activity and the at-risk limitations of the activity are computed on Form 6198, At-Risk Limitations.

EXAMPLE: Calculating partner's at-risk basis

Adam and Eve form a partnership. On January 1, each partner contributes $20,000 in cash to the partnership. During the year, the partnership borrows $100,000 that is secured by equipment they purchased. The loan is nonrecourse.

On July 6, the partnership distributed $6,000 each to Adam and Eve. As of December 31, the balance on the loan was $60,000. The partnership had a loss for the year of $40,000.

Adam's outside basis, before deducting any of the loss, is computed as follows:

Initial basis	$ 20,000
Share of liabilities (IRC Sec. 752)	30,000
Distribution	(6,000)
Basis, before deduction of loss	$ 44,000

The amount Adam has at-risk is computed as follows:

Initial amount at risk	$ 20,000
Share of liabilities (IRC Sec. 465)	0
Distribution	(6,000)
Amount at-risk	$ 14,000

The amount of loss that would be deductible by Adam (assuming no other loss limitations apply) is limited to the lesser of Adam's outside basis ($44,000) or the amount at-risk ($14,000). The remaining $6,000 ($20,000 loss less $14,000 deducted) is suspended until Adam has sufficient at-risk basis.

When the deductibility of a partner's losses is limited, suspended losses retain their character and may be absorbed in a subsequent year when the partner has enough basis.

NOTE: It is a practitioner's responsibility to compute a partner's loss limitations under the outside basis and at-risk rules and to track suspended losses. Practitioners should be sure they have all the necessary information to calculate the limitations, which includes completing basis worksheets and obtaining information not always reported on a Schedule K-1. If this is not done and there are losses on a return that should have been limited, the preparer may be subject to preparer penalties.

Passive Activity Loss Limitations

As previously noted, passive activity losses may be currently disallowed (IRC Sec. 469). Complete Form 8582, Passive Activity Loss Limitations, which will be attached to Form 1040. (Chapter 35 covers passive activity rules in further detail.)

NOTE: Schedule K-1 (Form 1065), section L, is a reconciliation of the capital account. Per Notice 2020-32, for partnership tax years ending on or after December 31, 2019, one of two methods will now be used to report partner tax capital: The Modified Outside Basis Method or the Modified Previously Taxed Capital Method.

Other Reportable Items by a Partner

A guaranteed payment (Schedule K-1, Line 4) is defined as a payment:

5. Made to a partner acting in the capacity as a partner in exchange for services performed or for the use of capital by the partnership, and

6. Not dependent on partnership income [IRC Sec. 707(c)].

> **PLANNING TIP:** Form 1065, Schedule K-1, line 4a reports guaranteed payments for services, while line 4b reports guaranteed payments for capital (sum total reported on line 4c).

Guaranteed payments made in exchange for services to a partnership are often called *partner salaries*, which is a misnomer because partners *are not* considered employees for FIT withholding and federal employment tax purposes [Rev. Rul. 69-184].

Guaranteed payments to an individual partner for services rendered and/or for the use of capital from a partnership engaged in a trade or business are considered self-employment (SE) income and should be reported as such on line 14, Schedule K-1 (code A), and included as SE income on that partner's individual return [Reg. §1.1402(a)-1(b)].

Accident and health insurance premiums paid by a partnership on behalf of its partners are treated as Section 707(c) guaranteed payments, provided the premiums are paid for services rendered as a partner and the payments are determined without regard to partnership income [Rev. Rul. 91-26].

If guaranteed payments are for services, the partnership-paid premiums are deductible by the partnership and included in the recipient partners' gross income, and they are included in the recipient partner's net SE income for SE tax purposes [Reg. §1.1402(a)-1(b)].

A partner can deduct 100% of the cost of the premiums as an adjustment to gross income on his or her individual income tax return, assuming the requirements of IRC Sec. 162(l) are met.

In Chief Counsel Advice (CCA) 201228037, the IRS allowed all Medicare insurance premiums to be qualified health insurance premiums for the SE health insurance deduction.

For a partner's medical insurance premiums to be deductible under IRC Sec. 162(l), the policy must be considered to be established under the partner's business. IRS Publication 535 (Business Expenses) states when a partner pays qualifying health insurance premiums with his own money (i.e., outside the partnership), the partner must submit proof of the payments to the partnership and be reimbursed with IRC Sec. 707(c) guaranteed payments from the partnership. Otherwise, according to IRS Pub. 535, the partner is not considered to have established a medical insurance plan for the business of being a partner, meaning no IRC Sec. 162(l) deduction is allowed.

Other deductions on Schedule K-1, line 13 include (not an exhaustive list)—

1. Charitable contributions are reported on Schedule A and Form 8283 (when applicable).

2. Investment interest expense.

3. Excess business interest expense.

4. Amounts paid for medical insurance.

5. Payments on behalf of a partner to a pension or IRA account.

SE earnings may be reduced by a partnership's Section 179 deduction. Assuming no limitation at the individual level, the amount flows to Schedule E, Part II.

Unreimbursed partnership expenses (UPE) may be deductible. Generally, partners (members) can deduct partnership expenses that they pay, or incur, personally as a deduction (Schedule E, part II).

If the expenses are of a type a partner is expected to pay without reimbursement under the partnership agreement or firm policy (written or unwritten), the partner can deduct the expenses on Schedule E [PLRs 9316003 and 9330004]. Conversely, a partner does not have UPE if the partnership would have honored the partner's request for reimbursement [PLR 9316003].

Per Schedule E instructions, UPE should be reported on line 28, column "", as a separate line item. The notation "UPE" should be entered in column (a) of the line item along with the name of the partnership.

A partner's unreimbursed business expenses should also be included as expenses on Schedule SE, thus reducing the partner's net SE income.

NOTE: In the Preamble to the final regulations under IRC Sec. 199A, the Treasury Department and the IRS declined to address whether deductions of unreimbursed partnership expenses, and the interest expense to acquire partnership and S corporation interests, reduced QBI for Section 199A deduction purposes.

However, the IRS provided a "QBI Flow Chart" in the instructions to the initial 8995 series forms (Qualified Business Income Deduction) and indicated that unreimbursed partnership expenses (along with other deductions) decrease qualified business income (QBI) for purposes of the Section 199A deduction.

PLANNING TIP: A partnership agreement may be amended up to the original due date of the partnership tax return (e.g., March 15 of the following year for a calendar-year partnership).

EXAMPLE: Treatment of unreimbursed partnership expenses

Jack is a partner in a landscaping business operating as a partnership. He uses his own truck for partnership business; this use is required by the partnership and is documented in the partnership operating agreement. He may deduct his own unreimbursed partnership expenses (UPE). The automobile expenses are reported on Schedule E, page 2, column "i"" on a separate line with the name of the partnership, followed by "UPE." This reduces Jack's self-employment income as well. Schedule E, line 27 should be marked "yes" to indicate UPE were deducted.

COURT CASE: In *Hines*, the taxpayer/partner was denied a business expense deduction because (a) he couldn't show that there was an agreement requiring him to pay the expenses, (b) he couldn't demonstrate that there was a longstanding partnership practice requiring him to pay the expenses, and (c) he couldn't substantiate the expenses (*Michael T. Hines v. Comm.*, TC Summary Opinion 2004-55; see also *Peter A. McLauchlan v. Comm.*, TC Memo 2011-289).

S CORPORATION SHAREHOLDERS

Basis

A common error is for taxpayers to deduct S corporation losses on their individual returns even though they don't have basis to take those losses.

A shareholder's stock basis is determined at the end of a corporation's tax year. Stock basis increases when a shareholder buys new shares or contributes capital and when income is passed through by the corporation. It decreases when a shareholder disposes of shares, when losses or deductions are passed through, and when nontaxable distributions are received.

In any year a shareholder's Schedule K-1 reflects a loss, the amount that may be deducted is limited to the shareholder's basis in stock (and debt) under IRC Sec. 1366, as well as his at-risk basis under IRC Sec. 465.

It is not the responsibility of a corporation to maintain basis records. The responsibility lies with the individual shareholder. The individual shareholder generally assigns that responsibility to his tax preparer. For new clients, request these records from the previous preparer.

PLANNING TIP: Schedule E, page 2, indicates that a basis computation is required if a taxpayer reports a loss, receives a distribution, disposes of stock, or receives a loan repayment from an S corporation.

Basis for determining a deductible loss is not the same as basis for the purpose of determining the gain or loss on the sale of stock. A loss deduction basis is made up of two parts:

1. The shareholder's adjusted basis in the stock itself, plus
2. The shareholder's adjusted basis in any bona fide loans from the shareholder to the corporation.

Losses not deducted in the current year are carried over and deducted if basis is restored in future years.

EXAMPLE: Treatment of S corporation shareholder's loss

Year	Adjusted Basis	Income or (Loss)	Amount Reported	Carryover
2019	$80,000	$(50,000)	$(50,000)	$0
2020	$30,000	$(70,000)	$(30,000)	$(40,000)
2021	$0	$30,000	$0	$(10,000)

If a suspended loss consists of more than one type of loss (e.g., partially ordinary, and partially capital), then any loss is carried over in proportion to future years.

The basis for each share of stock is computed separately.

EXAMPLE: Groups of shares with differing basis

Sally owns 400 shares of Cookies, Inc., an S Corporation. She acquired 100 shares on the day the corporation was formed by contributing property in exchange for stock (the transaction qualified under IRC Sec. 351). She subsequently received 100 shares as a gift from her father, 100 shares as an inheritance from her grandfather, and 100 shares she purchased from another shareholder. The basis of the stock of the four blocks of stock will likely be different. It is crucial that the basis of each share be properly calculated.

Initial Basis

The initial basis in stock is determined by a taxpayer's method of acquisition:

1. Stock acquired from a direct purchase uses the cost of the acquired shares.

2. Stock acquired through initial formation of the company uses the basis of property contributed to the corporation, reduced by the amount of property transferred back to the shareholder, plus any gain recognized on any of the transfers.

3. Stock acquired by converting from a C corporation retains the same basis as it held in the C corporation shareholder's hands. C corporation stock basis is usually unaffected by profits, losses or dividends reported by the C corporation.

4. Stock acquired by inheritance uses the FMV on the date of death (or alternate valuation date, if elected on the estate return). Basis is reduced by any amount that was included in the date of death value from income in respect of a decedent.

5. Stock acquired by gift uses the basis of the donor:

    a. If the FMV of the stock was less than its basis at the time of the gift, the basis would be the lower of the two values.

    b. IRC Sec. 469(j)(6) allows for an increase in gift basis when the gifted stock also includes suspended passive losses. The basis is increased by the amount of the suspended passive losses.

The giving of a note to a corporation promising to pay for stock does not increase stock basis. Making payments does increase stock basis.

Annual Basis Adjustments

A shareholder's basis is adjusted by various items of corporate income, gains, losses, expenses, and by distributions to the shareholder.

Basis is first increased by the following:

1. Flow-through, non-separately stated income from trade or business activities.

2. Flow-through separately stated income items such as rental income, portfolio income, capital gains, etc.

3. Tax-exempt income such as life insurance proceeds and municipal bond interest.
4. Depletion other than oil and gas.
5. General business credit recaptures that are added back to the basis of the respective asset.

EXAMPLE: Annual basis adjustment

Jason owns all the shares of Builders, Inc. an S corporation. A few years ago, he claimed a rehabilitation credit of $10,000 under IRC Sec. 47. The basis of the property was correspondingly reduced by $10,000. He sells the property, resulting in rehabilitation credit recapture of $4,000. The $4,000 recapture increases the basis of the property and increases Jason's stock basis under IRC Sec. 50(c).

Basis is then decreased by the following items, in this order:

1. Nontaxable distributions treated as a return of stock basis.
2. Nondeductible, non-capital expenses and certain oil and gas depletion deductions. Common examples include:
    a. The meals (50%) and entertainment (100%) adjustments.
    b. Federal income taxes attributable to C corporation activities.
    c. Tax credits from the general business credit that reduce basis.
    d. Nondeductible fines, penalties and similar expenses.

PLANNING TIP: Because nondeductible items reduce basis before flow-through losses, basis may be wiped out by non-deductible expenses.

3. Flow-through, non-separately stated losses from trade or business activities.
4. Flow-through, separately stated losses such as rental losses, capital losses, charitable contributions, Section 179 deductions, etc.

Basis can never be reduced below zero [IRC Sec. 1367(a)(2)]. Unused losses carryover to future years. Basis is reduced even if a taxpayer received no benefit from a loss or deduction. This can be a problem, especially for Section 179 deductions.

EXAMPLE: Reducing basis

Stu and Doug are the only shareholders of five different S corporations. Each S corporation can make an IRC Sec.179 election to the current limitation. The problem is that Stu and Doug are allowed only one current limitation on their individual returns. Any amount they cannot deduct on their individual return does not carry over, yet still reduces their basis in each of the S corporations.

Order and Timing of Basis Adjustments

Basis adjustments are normally made at the end of a corporation's tax year [Reg. §1.1367-1(d)]. Basis is first increased by pass-through income items and is then decreased by nontaxable distributions before considering the tax effects of pass-through items of loss and deduction [Reg. §1.1367-1(f)].

The order is important because:

1. It causes the tax effects of distributions to be determined by reference to basis at the end of a corporation's tax year after the adjustment for pass-through income and gain items.

2. It dictates that a shareholder's stock basis in a fiscal year S corporation is determined at the end of the corporation's tax year, rather than the shareholder's tax year.

If a shareholder disposes of stock during a corporation's tax year, adjustments to the basis of such shares of stock are effective immediately before the disposition.

EXAMPLE: Order and timing of basis adjustments

Scenario 1: Beth owns 50% of the outstanding stock of Buzz, Inc. On June 30, she sells her shares to Burt for $40,000. Her basis at the date of sale before adjustment is $10,000. At the year end the company shows a $100,000 profit, $25,000 of which is allocated to Beth. Her basis is increased by $25,000 and she reflects the profit as income on Schedule E for the year. Her gain on the stock sale will be $5,000 [($40,000 – ($10,000 + $25,000)].

Scenario 2: Gino's basis at the beginning of the year in Gadget, Inc., an S corporation in which he materially participates, is $13,000. At the end of the year, the corporation passes through a $14,000 non-separately stated loss and $3,500 of nondeductible meals (50%) and entertainment (100%) expenses.

Under the ordering rules, the $3,500 nondeductible amounts reduce basis before it is reduced by items of loss and deduction, so Gino can deduct only $9,500 ($13,000 − $3,500) of the $14,000 non-separately stated loss. The remaining $4,500 loss ($14,000 − $9,500) will carry over to be deducted in a future year when Gino has basis.

Taxpayers may elect to reduce basis by loss or deduction items before nondeductible, noncapital expenses, and certain oil and gas depletion deductions [Reg. §1.1367-1(g)]. If a taxpayer elects to reduce basis by items of loss or deduction before reducing basis by nondeductible, noncapital expenditures, nondeductible expenses are then carried forward to reduce basis in succeeding tax years. These expenses would simply disappear without the election.

PLANNING TIP: Consider making the election to accelerate losses and deductions but be careful. Due to the required carry forward of nondeductible expenses to eventually reduce basis, it is seldom a great idea. (See Gear Up's Business Entities manual for details.)

Distributions

IRC Sec. 1368(b) provides that a distribution by an S corporation that has no accumulated earnings and profits (E&P) is taxed to the shareholder under a two-tier approach:

1. First, the distribution is a tax-free reduction of the shareholder's basis in the S corporation's stock.

2. Any remaining distribution in excess of the shareholder's stock basis is treated as gain from the sale or exchange of the underlying stock [IRC Sec. 1368(b)(2)].

If an S corporation does have E&P from prior C corporation undistributed profits, a distribution is treated in the following order (note that special rules may apply to S corporations that have previously-taxed income (PTI) received before 1982):

1. Return of basis to the extent of AAA,

2. Taxable dividends to the extent of E&P,

3. Return of remaining basis (if any), then

4. Capital gain for any excess.

Losses Against Debt Basis

Once stock basis has been reduced to zero, losses and deductions are still allowed to the extent that a shareholder has debt basis.

Effective for transactions occurring on or after July 23, 2014, the IRS released final regulations clarifying the requirements for creating basis with debt. The old economic outlay test is no longer a requirement. The requirement is now strictly a test of bona fide indebtedness to the shareholder [Reg. §1.1366-2(a)(2)].

The regulations do not define what constitutes bona fide debt but defer to federal tax principals and facts and circumstances of the transaction. Shareholders wishing to obtain basis in debt should execute notes with terms comparable to a third-party transaction (e.g., marketable interest rates) and abide by repayment terms provided in the notes.

The final regulations provide three examples that may provide a shareholder basis in indebtedness depending on the facts and circumstances. The examples include a direct loan transaction between a shareholder and an S corporation, a back-to-back loan transaction where a taxpayer is the sole shareholder in two S corporations, and a loan restructuring through distributions where a taxpayer is again the sole shareholder in two S corporations [Reg. §1.1366-2(a)(2)(iii)]. It is noteworthy that the latter two examples do not require an actual economic outlay to obtain basis in indebtedness.

The same pass-through items of loss and deduction that affect stock basis (as previously discussed) are used to reduce debt basis. Distributions, however, do not reduce debt basis.

When a shareholder loans funds to an S corporation, the corporation should execute a note bearing a rate of interest that is at least equal to the applicable federal rate (AFR). Taking this step may prevent an IRS position that shareholder loans are not bona fide debt.

When basis in stock or shareholder debt has been reduced by losses, it is subsequently restored when income is generated. Capital contributions do not restore or increase debt basis. The ordering rules—

1. First restore basis in shareholder debt to the extent of prior basis reductions from losses, and basis in stock is increased only after debt basis has been restored [IRC Sec. 1367(b)(2)(B)].
2. If an S corporation passes through a combination of income, gain, losses, and deductions, debt basis is increased by the net amount that pass-through income and gains exceed losses, deductions, and non-dividend distributions [Reg. §1.1367-2(c)(1)].
3. In addition, if a debt is disposed of or repaid (either fully or partially) before the end of a corporation's tax year, any net income restores the debt's basis immediately before the disposition of the debt or the first repayment during the corporation's tax year [Reg. §1.1367-2(d)(1)].

Loan guarantees by shareholders are extremely common in small business lending. Loan guarantees by shareholders include acting as a surety, accommodation party, or other similar capacity relating to a corporate loan. The shareholder is only allowed to increase basis in the case of a guarantee when the shareholder makes a payment on the loan and only to the extent of the payment made.

COURT CASE: In *Phillips*, a taxpayer owned 50% of an S corporation that developed and sold real estate. The businesses debts were almost all guaranteed by the taxpayer. When the corporation defaulted, the taxpayer was sued, which resulted in liens against her property. The taxpayer increased her stock basis by her pro rata share of the unpaid judgment amounts. She argued that a basis increase was justified because the judgment against her demonstrated an actual economic outlay. The Tax Court disagreed. Upon appeal, the 11th Circuit affirmed the Tax Court's decision, holding that a basis increase would have been appropriate only if the taxpayer had made payments on the guaranties or judgment. [*Phillips, Rupert and Sandra v. Comm.*, 121 AFTR 2d 2018-1776 (CA 11)]

Repayment of Reduced Basis Shareholder Debt

Loan repayments are reported on both Schedule K and Schedule K-1 of Form 1120-S. An S corporation shareholder may recognize a taxable gain when a corporation repays all or part of a debt to the shareholder after the debt's basis has been reduced by pass-through losses.

Rev. Rul. 64-162 states if there is a written loan, the repayment and resulting income is treated as a sale or exchange of a capital asset and is therefore treated as a capital gain. The capital gain is long or short term depending on how long the shareholder held the note.

EXAMPLE: S Corporation repayment of reduced basis shareholder debt

Miron is the sole shareholder of a calendar year S corporation called Fusion, Inc. On March 15, Year 1 he loans the corporation $20,000 and executes a proper note. During the year, the company suffers a $15,000 loss. Because Miron has no stock basis, his basis in the debt is reduced by $15,000.

On July 1, Year 2, the company repays the $20,000 loan in full. The company earned $10,000 in Year 2.

Loan repayment		$ 20,000
Loan basis at 1/1/Year 2	5,000	

Income Year 2	10,000	
Loan basis at 12/31/Year 2		(15,000)
Gain on debt repayment		$ 5,000

Since basis in repaid debt was reduced, the $10,000 of income is applied first to the repaid debt. Miron reports $10,000 ordinary income and $5,000 long-term capital gain.

PLANNING TIP: A shareholder will benefit from using debt basis to deduct ordinary losses even if the debt is repaid before the complete restoration of the basis if held for at least a year and a day. The ordinary loss may have a tax benefit up to 37%, and the long-term capital gain has a maximum tax cost of 23.8% (assuming it is subject to the NIIT) or less.

NEW DEVELOPMENT: In 2020, the IRS added two additional items to Schedule K-1 for Form 1120-S. Taxpayers are required to report the shareholder's number of shares at the beginning and end of the year (Part II, line G) and the loans from the shareholder at the beginning and end of the year (Part II, Line H).

PPP PROCEEDS

The IRS has been silent on how to report PPP proceeds on Partnership and S corporation returns. Most experts agree that until the PPP proceeds are forgiven, the amount should be reported as a liability on the partnership/S corporation tax return.

However, for partnerships, when the PPP proceeds are forgiven, the amount should be reported on Schedule M-1, line 6a, as "Income recorded on books this year but not included on Schedule K, lines 1 through 11," and Schedule M-2, line 4, "Other increases." For S corporations, the amount should be reported on Schedule M-1, line 5a, as "Income recorded on books this year but not included on Schedule K, lines 1 through 10," and on Schedule M-2, line 3, column d, "Other adjustments account."

In both instances, the forgiven proceeds add basis to the partner or shareholder

TRUSTS AND ESTATES

Schedule K-1 (Form 1041) is used to report a beneficiary's share of income, deductions, gain, loss, credits, etc. for an estate or trust.

Typically, with a domestic grantor trust, all items of income, deductions, and credits attributable to the portion deemed owned by the grantor or other owner are reported on the grantor (or other owner's) income tax return. However—

1. The trust should not report on Form 1041 (or Schedule K-1) any part of the income that is taxable to a grantor or other deemed owner. Unless one of the optional alternate reporting methods is used, a skeleton Form 1041 is filed, along with a separate statement, generally referred to as a grantor letter, attached to the return detailing the items of income, deduction, and credit that are taxable to the grantor or other owner, as well as certain other required information about the grantor or other owner (name, address, and identification number) [Reg. §1.671-4(a)].

2. A Schedule K-1 should not be used to report the income or deductions attributable to the grantor or other owner.

The at-risk rules of IRC Sec. 465 and the passive activity rules of IRC Sec. 469 apply to estates and trusts, both at the fiduciary and beneficiary level.

The deduction for estate or generation-skipping transfer tax paid on income in respect of a decedent is reported on the beneficiary's Schedule A and is not subject to the 2% AGI floor. If the beneficiary does not itemize deductions, there will be no tax benefit from the deduction.

Final year deductions are those that can be passed to the beneficiary succeeding to the property in the estate or trust's year of termination.

NEW DEVELOPMENT: In 2020, the IRS issued proposed reliance regulations that included guidance on determining the character, amount, and allocation of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or non-grantor trust.

The proposed regulations retain the tax character of the three categories of expenses that may be distributed on a final Form 1041 to the beneficiaries, to allow the expenses to be separately stated and to facilitate reporting to beneficiaries. Specifically, as an amount allowed in arriving at adjusted gross income (NOL or capital loss carryover); a non-miscellaneous itemized deduction; or a miscellaneous itemized deduction. The character of these deductions does not change when succeeded to by a beneficiary on termination of the estate or trust.

The following amounts should be reported, if applicable (Schedule K-1, box 11, Final year deductions):

1. Excess deductions: Section 67(e) expenses.

2. Excess deductions: non-miscellaneous itemized deductions.

3. Unused capital loss carryover (Code C for short-term, Code D for long-term).

4. NOL carryover (Code E for regular tax, Code F for AMT).

WHERE TO GO FOR MORE INFORMATION

- IRS Publication 925, *Passive Activity and At-Risk Rules*

- IRS Publication 541, *Partnerships*

- IRS guidance on S Corporation Stock and Debt Basis at **www.irs.gov/businesses/small-businesses-self-employed/S corporation-stock-and-debt-basis**

- Instructions for Schedule K-1 and Forms 1041, 1065, and 1120S

CHAPTER 36: SALES AND OTHER DISPOSITIONS OF BUSINESS ASSETS

Learning Objectives

Completion of this chapter will enable participants to—

- Summarize the impact of unrecaptured prior year Section 1231 losses.
- Determine the tax impact of a taxpayer's abandonment of depreciable property.

SECTION 1231 GAINS AND LOSSES

IRC Sec. 1231 governs property used in a trade or business and involuntary conversions. Sales or exchanges of real, depreciable, or amortizable property used in a trade or business and held for more than one year are Section 1231 qualifying sales or exchanges, with certain agricultural asset exceptions (e.g., cattle and horses used in a trade or business for draft, breeding, dairy or sporting purposes).

For business property failing to meet the holding-period requirement, all gains and losses are ordinary.

EXAMPLE: Failing to meet the Section 1231 holding requirements

Scenario 1: Dante purchases a steeply discounted milling machine at auction. He hauls it to his shop, where it sits uninstalled and unused. Dante ultimately decides the machine is unnecessary and sells it nine months after purchasing it to a competitor. Dante realizes a $50,000 gain on the sale. He believes that he will be able to offset the gain against substantial capital loss carryforwards. Unfortunately for Dante, since he did not hold the property for more than one year, the entire gain is ordinary.

Scenario 2: Mercedes sells a prize bull (held for breeding) that she has owned for a year and a half at a $500,000 gain. She assumes that, except for depreciation recapture, the gain will be a long-term capital gain subject to a maximum tax rate of 20%. Mercedes is shocked to learn that the Section 1231 holding period requirement for sales or exchanges of cattle and horses held for draft, breeding, dairy or sporting purposes is 24 months or more. Therefore, the sale fails to meet the Section 1231 requirements, and the entire gain of $500,000 is taxed as ordinary income.

Generally, net gains from Section 1231 property are treated as long-term capital gains while net losses are treated as ordinary losses:

1. If Section 1231 losses exceed gains, the net Section 1231 loss for the year is ordinary.
2. If Section 1231 gains exceed losses, the net Section 1231 gain is treated as a long-term capital gain if no unrecaptured Section 1231 losses exist from prior years.

RECENT DEVELOPMENT: Effective December 22, 2017, IRC Sec. 1400Z-2 provides a temporary deferral of inclusion in gross income for eligible capital gains invested in Qualified Opportunity Funds (QOF) within 180 days of sale or exchange. IRC Sec. 1400Z-2 also provides a permanent exclusion of capital gains from the sale or exchange of an investment in the QOF if the investment is held for at least 10 years.

In January 2020, the IRS issued final Regulations under IRC Sec. 1400Z-2. The final Regulations provide that eligible gains that may be deferred under IRC Sec. 1400Z-2(a)(1)(A) include gains from the sale or exchange of property described in IRC Sec. 1231(b) (depreciable or real property that is used in the taxpayer's trade or business and held for more than one year) that is not required to be characterized as ordinary income by the recapture rules in IRC Sec. 1245 or 1250, regardless of whether those gains would be capital or ordinary in character under IRC Sec. 1231(a) [without regard to IRC Sec. 1231(a)(4)] [Reg. §1.1400Z2(a)-1(b)(11)].

Unlike the net approach of the proposed regulations, the final regulations adopt a gross approach to qualified Section 1231 gains.

The final regulations provide that the 180-day period for investing an amount of qualified Section 1231 gain for which a deferral election is to be made begins on the date of the sale or exchange that gives rise to the eligible Section 1231 gain [Reg. §1.1400Z2(a)-1(b)(7)].

See Chapter 21 for a comprehensive discussion of QOFs.

PLANNING TIP: Reg. §1.199A-3 provides rules on the determination of a trade or business' qualified business income (QBI) for purposes of the Section 199A deduction.

According to the final regulation, no item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, is taken into account as QBI.

However, this provision does not apply to the extent an item is treated as anything other than short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss (e.g., ordinary income due to unrecaptured Section 1231 losses).

If there are unrecaptured prior-year Section 1231 losses, Section 1231 net gains in subsequent years are taxed as ordinary income to the extent of those unexpired prior-year unrecaptured Section 1231 losses [IRC Sec. 1231(c)]:

1. Unrecaptured Section 1231 losses are the aggregate net Section 1231 losses deducted in the five preceding tax years that have not offset Section 1231 gains.

2. These losses are considered recaptured in chronological order (i.e., FIFO) and expire if they have not been recaptured after five years.

3. Unrecaptured Section 1231 losses cannot be carried back to affect the character of prior year Section 1231 gains; they can only be carried forward.

EXAMPLE: Calculating Section 1231 gains and losses

Oliver sells a Section 1231 qualifying asset in 2021, resulting in a Section 1231 gain of $13,000. Historically, Oliver had the following net Section 1231 gains and losses:

- Tax year 2016: ($3,000)
- Tax year 2017: ($8,000)

- Tax year 2018: $11,000
- Tax year 2019: ($6,000)
- Tax year 2020: $2,000

Net Section 1231 losses = ($4,000)

The Section 1231 gain for 2020 is treated as follows:

- Ordinary income (transferred to Part II of Form 4797): $4,000
- Capital gain (to Schedule D): $9,000

Several IRC sections convert what would otherwise be a Section 1231 gain (capital gain) into ordinary income:

1. **Section 1245 property.** Depreciation (or amortization) taken on depreciable or amortizable tangible or intangible personal property is subject to recapture as ordinary income. The amount of the gain treated as ordinary income is the lesser of the sum of all allowable depreciation or amortization taken or the gain realized on disposition.
2. **Section 1250 property.** Real property not classified as Section 1245 property is Section 1250 property. When Section 1250 property is disposed of, additional depreciation or depreciation in excess of straight-line depreciation is subject to recapture as ordinary income. Additional depreciation for Section 1250 property held one year or less is all depreciation taken on the property [IRC Sec. 1250(b)(1)].
3. **Real property is generally Section 1250 property, not Section 1245 property.** However, nonresidential real property acquired after 1980 and before 1987 and for which an accelerated ACRS method was used, is considered Section 1245 property and subject to Section 1245 recapture rather than IRC Sec. 1250 recapture.

EXAMPLE: Calculating Section 1231 gain

Juanita sold her residential rental property in Palm Springs for $400,000 on January 3, 2020. Juanita's income from earnings and other sources was $450,000. She originally bought the rental realty for $240,000 in 2014 and has partly depreciated the structure. Her basis on the date of the sale was $189,400.

Sales price		$ 400,000
Original cost	$ 240,000	
Accumulated depreciation	(50,600)	(189,400)
Gain on sale		$ 210,600
IRC Sec. 1250 gain taxable at a maximum of 25%		$ 50,600
Long-term capital gain taxable at a maximum of 20%		$ 160,000

Gain recognized from the sale or exchange of depreciable property between related persons is treated as ordinary gain (i.e., IRC Sec. 1231 does not apply) [IRC Sec. 1239(a)]. A *related person* includes an individual and all entities controlled by that individual. A *controlled entity* includes more-than-50%-owned corporations (based on stock value) and partnerships (based on capital or profits ownership) [IRC Sec. 1239(b)].

Other *related persons* include an individual and a trust in which such person is a beneficiary (other than a remote contingent beneficiary), an estate and a beneficiary of the estate, and two or more partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests.

Constructive ownership rules apply in determining an individual's ownership in a related entity.

PLANNING TIP: Family members (e.g., parents and children) are not considered related persons for purposes of the rules under IRC Sec. 1239(a). Thus, Section 1231 treatment is allowed for qualifying gains from such installment sales.

ABANDONMENTS

The *abandonment* of property is a disposition of property. A taxpayer abandons property when voluntarily and permanently giving up possession and use of the property with the intention of ending ownership without passing it on to anyone else.

When a taxpayer owns and abandons property used in a business or in a transaction entered into for profit, a loss deduction may be claimed. Abandonment losses attributable to business property generally are deductible in the year sustained without regard to any capital loss limitations. For depreciable property, abandonment results in a loss deduction allowable to the taxpayer under the depreciation and cost recovery regulations [Reg. §1.168(i)-8(b)(2)].

A loss is allowed for the adjusted basis of the property when irrevocably discarded by a taxpayer. To qualify for recognition of loss from physical abandonment, the intent of a taxpayer must be irrevocably to discard the asset so that it will neither be used again by the taxpayer nor retrieved by the taxpayer for sale, exchange, or other disposition.

For non-depreciable property (e.g., land), a loss deduction is allowed under IRC Sec. 165(a) for the abandonment if—

1. The loss is incurred in a business (or a transaction entered into for profit),
2. The loss arises from the sudden termination of a property's usefulness in a business, and
3. A business is discontinued, or the property is permanently discarded.

The cost of improvements made to leased property by a lessee is recovered under the MACRS depreciation rules without regard to the term of the lease. If, upon termination of the lease, there is unrecovered cost and the property is lost to the lessee, an abandonment loss is computed with reference to the remaining adjusted basis of the improvements as though the property had been sold for a zero sales price in the year it was abandoned [Reg. §1.168(i)-8(c)(3)(ii)].

EXAMPLE: Treatment of abandoned property

Sloane, a mortgage broker, signed a five-year lease for office space beginning March 1, 2016. She spent $15,000 on leasehold improvements. Sloane did not renew her lease when it expired in February 2021, and she moved to a new office, abandoning all improvements. Because leasehold improvements are depreciated using real property recovery periods, Sloane's adjusted basis in the improvements at the time of abandonment was $13,076 ($15,000 − $1,924 accumulated depreciation). Thus, she may claim a $13,076 abandonment loss on Part II (Ordinary Losses) of her 2020 Form 4797.

Special rules may apply to abandoned mineral property (e.g., oil or gas lease or well) [IRC Sec(s). 165 and 612] and partnership interests [IRC Sec. 165(a)].

A loss deductible under IRC Sec. 165 must be evidenced by a completed transaction that is established by an identifiable event [Reg. §1.165-1(b)]. For an abandonment loss, a taxpayer must also show both owner's intent to abandon the asset and an affirmative act of abandonment. Intent to abandon is normally determined by facts and circumstances. Identifiable events such as plugging an oil well, scrapping machinery, and discontinuing a line of business would generally be considered affirmative acts that constitute property abandonments.

A loss is deductible in the year sustained, which is the year the identifiable event occurs [Reg. §1.165-2(a)]. A taxpayer bears the burden of proof in establishing that a loss was sustained in the same year the loss was claimed on the return.

Losses on abandonment of business property are reported on Form 4797 (Part II) as an ordinary loss (IRS Pub. 544). However, if the property was abandoned due to a casualty, the loss is reported on Form 4684.

Reg. §1.1402(a)-6 states that gain or loss from disposition of business property (other than inventory) is excluded in determining net earnings from self-employment. According to Reg. §1.168(i)-8(b)(2), the term disposition includes an abandonment.

It is possible that a gain on an abandonment may occur in certain circumstances [Reg. §1.168(i)-8(e)(2)] (e.g., if the abandoned asset is subject to nonrecourse indebtedness).

COURT CASE: In *Cuthbertson*, the Tax Court noted that "An asset is abandoned when it is permanently retired from use in the trade or business." The taxpayers asserted that certain golf course improvements were abandoned; the court was unpersuaded given that a related entity of the taxpayers continued to maintain and operate the golf course (including the improvements) in conjunction with a residential real estate project. (*Cuthbertson v. Comm.*, TC Memo 2020-9)

RECAPTURE RULES FOR SECTION 197 ASSETS

IRC Sec. 197 covers a broad range of intangible assets that are amortizable over a period of 15 years. Examples of Section 197 assets include goodwill, customer lists, and covenants not to compete acquired as part of purchasing a business.

When intangible assets are sold at a gain, they are treated as one asset in one sale, regardless of how many different intangible assets are sold, for the purpose of amortization recapture [IRC Sec. 1245(b)(8)(A)].

NOTE: Intangible assets sold at a loss are excluded [IRC Sec. 1245(b)(8)(B)]. This eliminates a taxpayer's ability to plan around ordinary income recapture. This rule exists to ensure the full amount of Section 1245 recapture is reported and taxed, regardless of how a buyer and seller allocate the purchase/sale price for the intangible assets.

EXAMPLE: Treatment of Section 197 intangible assets during sale of a business

Lionel agrees to sell his profitable bookkeeping practice to Lisa for $100,000. He bought the practice five years ago for $87,000, at which time he allocated the purchase price as $45,000 to goodwill, $30,000 to a customer list, and $12,000 to the trademark. Lionel has been amortizing each asset using a 15-year life and the straight-line method. His amortization schedule at the time of sale includes:

	Goodwill	Customer List	Trademark	Totals
Original cost	$ 45,000	$ 30,000	$ 12,000	$ 87,000
Accumulated amortization	(15,000)	(10,000)	4,000)	(29,000)
Remaining basis	$ 30,000	$ 20,000	$ 8,000	$ 58,000

Lisa and Lionel agree to allocate the $100,000 sales price as follows: $72,000 to goodwill, $20,000 to customer list, and $8,000 to the trademark. Lionel mistakenly believes he will only have to recognize $15,000 accumulated amortization on the goodwill as ordinary income and the balance of the gain will be capital gain. Lisa doesn't care one way or the other, as all purchased assets are written off in the same manner and method.

The IRC requires all the Section 197 intangible assets to be treated as one asset for the purpose of amortization recapture, regardless of how the sales price is allocated. In this example, Lionel would have Section 1245 ordinary income recapture of $29,000 and capital gain income of $13,000.

RECAPTURE RELATED TO SECTION 179 EXPENSING

IRC Sec. 179 requires that the property must be used more than 50% in an active trade or business, and if the trade or business use of the property drops to 50% or less at any time before the end of the property's recovery period, the deduction is recaptured as ordinary income [IRC Sec. 179(d)(10); Reg. §1.179-1(e)].

The amount recaptured is the difference between the IRC Sec. 179 deduction and the depreciation that would have otherwise been taken on the property from the date the property was placed in service, through the year of recapture. This recapture is reported on Form 4797, Part IV. It is then carried to the "other income" line on whatever form (or schedule) the deduction was originally claimed. This may also cause the adjustment to be subject to self-employment tax. The basis of the property is increased for future depreciation calculations by the amount of any recapture.

EXAMPLE: Section 179 expensing recapture

On January 1, Year 1, Lamora purchased and placed into service $10,000 of used video equipment for exclusive use in her advertising business. Lamora elected to deduct the $10,000 of cost under IRC Sec. 179. On June 15, Year 2, Lamora purchased new video equipment for use in her business and converted the equipment purchased in Year 1 to personal use property.

Had the Year 1 equipment been depreciated under MACRS the allowable depreciation would have been \$2,000 (\$10,000 × 100% business use × 20%) for Year 1 and \$1,600 [\$10,000 × 32% × 50% (half-year convention in year of disposition)] for Year 2. Thus, the recapture amount is \$6,400, the difference between the \$10,000 IRC Sec. 179 deduction claimed and the \$3,600 (\$2,000 + \$1,600) depreciation that would have been taken if the IRC Sec. 179 expense had not been claimed. The recapture is reported in Part IV of Form 4797. The recapture is carried to the same form on which the deduction was originally claimed (e.g., Schedule C) and reported as other income. The basis in the Year 1 equipment is increased by the \$6,400 of recapture income. There is no double taxation on the gain.

PLANNING TIP: As discussed, a taxpayer must recapture the benefit of the Section 179 expensing deduction if the Section 179 property is not predominantly used in the taxpayer's trade or business at any time before the end of the property's depreciation recovery period.

Bonus depreciation, except in the case of listed property, doesn't have a similar recapture requirement.

SECTION 280F LISTED PROPERTY RECAPTURE

IRC Sec. 280F limits depreciation on listed property, subject to the rules of the alternative depreciation system (ADS), whenever business use is 50% or less. If qualified business use percentage is greater than 50% in the first year, but then falls to 50% or less, excess depreciation must be recaptured. The recapture rules include conversion of an automobile to predominantly personal use (Temp. Reg. §1.280F-3T). *Excess depreciation* is the excess of Section 179 and other depreciation deductions allowed in years that a vehicle's business use exceeded 50% over the depreciation that would have been allowed in those years using ADS, straight-line depreciation over a five-year recovery period.

Recapture income is computed and reported on Form 4797, Part IV. It is then reported as other income on Schedule C, E, or F, depending on where the original deduction was claimed. Recapture income attributable to trade or business property is subject to self-employment tax. The basis in the property is adjusted upward by any amount recaptured.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRS Pub. 946, *How to Depreciate Property*
- IRS Pub. 225, *Farmer's Tax Guide*

CHAPTER 37: INSTALLMENT SALES

Learning Objectives

Completion of this chapter will enable participants to—

- Define an installment sale.
- Assess the election out of the installment method.

OVERVIEW

IRC Sec. 453(a) generally requires income from an installment sale to be recognized under the *installment method*. Use of the installment method does not impact the tax treatment of a gain as capital gain or ordinary income. It only affects the timing of gain recognition.

PLANNING TIP: The installment method postpones recognition of income from an underlying sale until the proceeds from the sale are received. This is a great strategy to defer income.

Even if the installment method is used to report gain from the sale of property, all ordinary income recapture must be included in income in the year of sale [IRC Sec. 453(i)]. Thus, only gain in excess of ordinary income recapture can be reported on the installment method. For this purpose, the term recapture income means the aggregate amount that would be treated as ordinary income under IRC Sec. 1245 or 1250 for the taxable year of the disposition if all payments were received in the year of disposition [IRC Sec. 453(i)(2)].

Special rules apply when an installment gain includes unrecaptured Section 1250 gain.

Installment sales are reported on Form 6252, Installment Sale Income.

Alternative minimum tax (AMT) treatment follows the method used for regular tax treatment. Accordingly, when the installment sale method is used for regular tax, it is allowed for AMT.

PLANNING TIP: In 2021, a taxpayer with an eligible capital gain can invest that gain into a Qualified Opportunity Fund (QOF) and elect to defer part of or all the gain that would otherwise be included in income until December 31, 2026. The taxpayer also may be able to permanently exclude gain from the sale or exchange of an investment in a QOF if the investment is held for at least 10 years. See Chapter 21 for a comprehensive discussion of Qualified Opportunity Fund investments.

INSTALLMENT SALE DEFINED

The term *installment sale* means a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The term *does not* include—

1. Dealer dispositions.
2. Inventories of personal property [IRC Sec. 453(b)(2)(B)]. This includes a disposition of personal property which is required to be included in the inventory of a taxpayer if on hand at the close of the taxable year.

3. Any disposition of personal property under a revolving credit plan.

4. Stock or securities traded on an established securities market.

The term *dealer dispositions* means any of the following dispositions:

1. Personal property. Any disposition of personal property by a taxpayer who regularly sells or otherwise disposes of personal property of the same type on the installment plan [IRC Sec. 453(l)(1)].

2. Real property. Any disposition of real property which is held by a taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business [IRC Sec. 453(l)(2)].

The term *dealer disposition* does not include:

1. Property used or produced in the trade or business of farming [IRC Sec. 453(l)(2)(A)].

2. Any residential lot sold to individuals, provided the dealer or any related person is not obligated to make any improvements to such lot [IRC Sec. 453(l)(2)(B)(ii)(II)].

3. A timeshare right to use or own residential real property for not more than six weeks per year or rights to use specified campgrounds for recreation [IRC Sec. 453 (l)(2)(B)(ii)(I)].

NOTE: Under the residential lot and timeshare exceptions, a dealer is required to pay interest on the unpaid tax as computed under IRC Sec. 453(l)(3)(B).

KEY DEFINITIONS

Selling price is the entire cost of a property to the buyer [Reg. §15A.453-1(b)(2)(ii)], and includes:

1. Cash,

2. Fair market value (FMV) of any property conveyed to the seller,

3. Notes, mortgages, and the seller's liabilities (such as liens, accrued interest and taxes) the buyer assumes or pays, and

4. Seller's selling expenses paid by the buyer.

Contract price is the selling price, less qualifying indebtedness assumed by a buyer. It is the gross amount a seller will receive and is equal to the selling price when no debts are involved [Reg. §15A.453-1(b)(2)(iii)]. The contract price also includes the amount by which the mortgages, debts, and other liabilities assumed or taken by a buyer exceeds the seller's adjusted basis for installment sale purposes.

Qualifying indebtedness includes any mortgage or other indebtedness encumbering a property, plus any indebtedness not secured by the property, but incurred or assumed by a purchaser incident to the acquisition of the property in the ordinary course of business [Reg. §15A.453-1(b)(2)(iv)].

Gross profit is the sale price, less selling expenses and the adjusted basis. The gross-profit percentage is calculated by dividing the gross profit by the total contract price (not the selling price) [Reg. §15A.453-1(b)(2)(v)].

Payments received in the year of sale include:

1. The gross down payment, which includes any earnest money that becomes part of a contract.

2. Any later installments received in the year of sale in cash or property other than evidence of indebtedness of the buyer, such as notes or other purchase-money obligations [Reg. §15A.453-1(b)(3)].

3. Any bond or other evidence of indebtedness payable on demand or readily tradable [Reg. §15A.453-1(e)(1)(I)].

4. Liabilities of a seller paid by the buyer in the year of the sale (e.g., liens, accrued interest and taxes).

5. If a buyer assumes a mortgage and the mortgage assumed is in excess of the seller's basis, plus selling expenses, then this excess is included in determining the payments in the year of sale. This also increases the contract price [Reg. §15A.453-1(b)(3)(i)].

6. Any amounts actually or constructively received.

7. Any recapture under IRC Sec(s). 1245 and 1250 [including the expense allowance under IRC Sec. 179 and bonus depreciation under IRC Sec. 168(k)] will be treated as ordinary income in the year of disposition, as if all payments were received in the same year. The recapture income cannot exceed total gain realized on a sale. Gain recaptured is added to the basis of the property sold for purposes of computing the gain to be reported on the installment method.

8. Depreciation on unrecaptured Section 1250 gain provides that if a gain from an installment sale of realty consists of both 25% unrecaptured depreciation gain and 15% (or 20%) long–term capital gain, then the taxpayer must report and pay tax on all the 25% gain before any 15% (or 20%) long-term capital gain is reported [Reg. §1.453-12].

PLANNING TIP: The two most overlooked aspects of installment sales are depreciation recapture and debt relief in excess of basis. Either of these items can be a tax trap for the unwary. Practitioners should always check with taxpayers on the amount of debt relief and the nature of the property being sold, and consider any previous depreciation taken. Tax on this is due in the year of sale, even on an installment sale!

SPECIAL SITUATIONS

Single Sale of Several Assets

If a taxpayer sells different types of assets in a single sale, he must identify each asset to determine whether he can use the installment method to report the sale of that asset.

Unless an allocation of the selling price has been agreed to by both parties in an arm's-length transaction, a taxpayer must allocate the selling price to an asset based on its FMV. If a buyer assumes debt or takes property subject to a debt, they must reduce the FMV of the property by the debt. This becomes the net FMV.

A sale of separate and unrelated assets of the same type under a single contract is reported as one transaction under the installment method. However, if an asset is sold at a loss, it cannot be reported on the installment method and must be reported separately. All remaining assets sold at a gain are reported together.

Sale of a Business

The installment sale of an entire business for one overall price under a single contract isn't the sale of a single asset. To determine whether any of a gain on the sale of a business can be reported on the installment method, a taxpayer must allocate the total selling price and the payments received in the year of sale between each of the following classes of assets [Rev. Rul. 68-13]:

1. Assets Sold at a Loss

2. Real and personal property eligible for the installment method.

3. Real and personal property not eligible for the installment method, including inventory, dealer property, and stocks and securities.

Sales to Related Parties

Installment reporting is not allowed for sales of depreciable property between certain related persons [IRC Sec. 453(g)]. *Depreciable property* is any property that can be depreciated by the purchaser [IRC Sec(s). 1239(a) and 453(f)(7)]. When the disallowance rule applies, all payments are deemed to be received in the year a sale occurs. Furthermore, a purchaser cannot increase the basis of property until the income has been reported by the seller [IRC Sec. 453(g)(1)(C)]. Here, a *related person* includes an individual and all entities controlled by that individual. A *controlled entity* includes more than 50% owned corporations (based on stock value) and partnerships (based on capital or profits ownership) [IRC Sec(s). 453(g)(3) and 1239(b)].

Other related persons include an individual and a trust in which such person is a beneficiary (other than a remote contingent beneficiary), an estate and a beneficiary of the estate, and two or more partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests.

Constructive ownership rules apply in determining an individual's ownership in a related entity.

PLANNING TIP: Family members (e.g., parent and child) are not considered related persons for purposes of the rules under IRC Sec. 453(g). Thus, installment sales of depreciable property between relatives are allowed, and Section 1231 treatment is allowed for qualifying gains from such installment sales (with the exception of ordinary income recapture).

An exception to the prohibition of installment reporting for related persons allows installment reporting if a taxpayer can demonstrate that the principal purpose of the transaction was not the avoidance of federal income taxes [IRC Sec. 453(g)(2)].

Gain recognition on an installment sale of property to a related party is accelerated if the related party disposes of the property within two years of the installment sale (i.e., the first disposition) and the second disposition is before all payments on the first disposition were received [IRC Sec. 453(e)].

Under the two-year disposition rule, a *related party* generally includes a spouse; child; grandchild; parent; sibling; or a related C or S corporation, partnership, estate, or trust [IRC Sec. 453(f)(1)]. A *second disposition* includes a sale, exchange, or gift of property.

The initial seller is treated as having received proceeds equal to the excess of the amount realized on the second disposition (or, if less, the contract price on the first disposition) over the actual payments received on the initial sale. However, gain is not accelerated under any of the following circumstances [IRC Sec(s). 453(e)(6) and (7)]:

1. The second disposition is the result of an involuntary conversion under IRC Sec. 1033, and the first disposition occurred before the threat of conversion.

2. The second disposition occurs after the earlier of the death of (a) the person making the first disposition or (b) the person who acquired the property in the first disposition.

3. Neither the first nor the second disposition had tax avoidance as one of its principal purposes.

Debt Reduction by Seller

If an installment note originated from the purchase of property and at some future date the seller reduces the outstanding installment obligation for a solvent purchaser, then the buyer and the seller treat the reduction of debt as a reduction of the original purchase price [Rev. Rul. 72-570 and IRC Sec. 108(e)(5)].

The buyer will reduce the basis of the property purchased. Upon subsequent disposition, this basis reduction will be subject to the recapture provisions of IRC Sec(s). 1245 and 1250.

The seller will re-compute the gross profit and gross profit percentage using the adjusted sale price, then subtract profit already reported and spread the remaining gain over the remaining installments.

NOTE: This does not apply when a third-party lender reduces a buyer’s indebtedness [Rev. Rul. 92-99].

ELECTING OUT OF THE INSTALLMENT SALE METHOD

The installment sale rules are mandatory for eligible sales unless the taxpayer elects out of installment reporting.

It may be beneficial for a taxpayer to elect out of the installment method and report an entire gain in the year of sale. This may be advantageous when a taxpayer has expiring carryovers (e.g., pre-TCJA net operating losses), little taxable income or a tax loss, the disposed of activity has suspended passive activity losses, or the taxability of social security benefits is affected. The election is made by reporting the entire sale on Form 8949, Schedule D and/or Form 4797. No additional reporting is required. An election must be done on a timely filed tax return, including extensions.

If a return is timely filed without making an election, an election can still be made by filing an amended return within six months of the due date of the return, excluding extensions. Write “Filed pursuant to Section 301.9100-2” at the top of the amended return. An election is typically binding and only revocable with IRS consent [IRC Sec. 453(d)(3)].

NEW DEVELOPMENT: In PLR 202024005, the taxpayer was granted permission to revoke its election out of the installment method with respect to the sale of certain property, provided that taxpayer revoked the election within 75 days, and filed amended returns on which a portion of gain from the sale was reportable under the installment method.

DISPOSITION OF AN INSTALLMENT OBLIGATION

An installment obligation may be sold, satisfied at other than face value, or otherwise disposed of before all gain from the installment sale has been recognized. In such cases, the remaining gain must generally be recognized upon disposition [IRC Sec. 453B]. However, certain transfers do not trigger unrecognized gain (e.g., contributions to a partnership under IRC Sec. 721).

Gain or loss on disposition is determined in one of two ways, depending on whether an obligation was:

1. Satisfied at other than face value, sold, or exchanged; or

2. Distributed, transmitted, or disposed of other than by sale or exchange (e.g., by gift, dividend, cancellation, or in any way other than by sale or exchange).

Any gain or loss is considered as resulting from the sale or exchange of the property for which the installment obligation was received, so the character of the gain or loss is the same as that of the original sale [IRC Sec. 453B(a)].

The gain or loss on a sale or exchange of an installment obligation (including satisfying the obligation for less than face value) is the difference between the obligation's basis and the amount realized. Basis is the excess of the obligation's face value over the income that would be reported if it had been paid in full [IRC Sec. 453B(b)].

The gain or loss on a disposition other than by sale is the difference between an obligation's basis and its FMV at the time of disposition. If an obligation is canceled or becomes unenforceable, it is considered a disposition other than by sale. In addition, if a canceled or unenforceable obligation is between related parties, the FMV of the obligation cannot be less than its face value [IRC Sec. 453B(f)(2)].

REPOSSESSION BY SELLER

Repossession by a seller of property originally sold on the installment sale method can create a gain or loss to the seller. The gain or loss is calculated differently depending on whether the repossession is for the sale of personal property or real property. In all cases, the repossession must partially satisfy the installment obligation and the obligation must be secured by the property being repossessed.

Repossessions of personal property can cause a gain or loss and perhaps a bad debt (IRC Sec. 453B). The difference between the FMV of a repossessed property and a seller’s basis, plus repossession costs, is recognized as a gain or loss. *Basis* equals the unpaid balance on the installment note less unrecognized profit. A taxpayer’s basis after a repossession will be the FMV of the property at the date of repossession. If repossessed property does not satisfy the obligation, there may also be a bad debt.

Repossession rules for real property allow a seller to keep their original basis in the property. The repossession puts a seller in the same position as before the installment sale. A seller will recover the original basis on any future resale of a property. Therefore, all principal payments previously received from a buyer are considered income (IRC Sec. 1038).

Any part of the payments previously received from a buyer on an original sale that were not included in taxable income are treated as a return on the taxpayer’s original basis and are taxable at the time of repossession. Taxable gain is limited to the gross profit on the original sale, less previous gain reported on the sale and repossession costs. The gain will be the same as the character of the gain on the original sale. A seller's basis is the adjusted basis in the installment note, plus repossession costs and taxable gain on the repossession.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 537, *Installment Sales*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*

CHAPTER 38: LIKE-KIND EXCHANGES

Learning Objectives

Completion of this chapter will enable participants to—

- Assess the tax advantages of a Section 1031 exchange.
- Identify boot, the relinquished property, and the replacement property.

WHAT'S NEW

1. In November 2020, the IRS issued final regulations that added a definition of real property for purposes of Section 1031 tax-free like-kind exchanges.
2. The Regulations also provide a rule addressing a taxpayer's receipt of personal property that is incidental to real property the taxpayer receives in an otherwise tax-free like-kind exchange.

IRC SEC. 1031 OVERVIEW

No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such property is exchanged solely for property of a like-kind which is held either for productive use in a trade or business or for investment [IRC Sec. 1031(a)(1)].

Mandatory nontaxable exchange treatment applies if all the following requirements are satisfied (IRC Sec. 1031):

1. The form of the transaction is a sale or exchange.
2. Both the property exchanged, and the property received, must be real estate held either for the productive use in a trade or business or for investment [IRC Sec. 1031(a)(1)].
3. The properties transferred and received are like-kind property.

The transaction must involve a direct exchange of property to qualify as a like-kind exchange. An exchange occurs when a taxpayer conveys property (i.e., relinquishes property) to the same party from whom the taxpayer acquires property (i.e., replacement property). The regulations allow the use of a qualified intermediary to accommodate multi-party exchanges. *Like-kind exchanges* can include business for business, business for investment, investment for business, or investment for investment property. However—

1. Property held for personal use, inventory, personal property, and partnership interests *do not* qualify under the like-kind exchange provisions.
2. Real property held by a developer primarily for sale (as opposed to held for productive use in a trade or business or for investment) *does not* qualify [IRC Sec. 1031(a)(2)]

As used in IRC Sec. 1031(a), the term *like-kind* refers to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class [Reg. §1.1031(a)-1(b)]. Gain (or loss) must be recognized in certain situations. Taxpayers who engage in like-kind exchanges of investment or business property must file Form 8824, Like-Kind Exchanges, for each exchange.

If a taxpayer wants to recognize gain (or loss), the transaction should be structured to avoid a mandatory like-kind exchange treatment.

LIKE-KIND REAL ESTATE

The term *like-kind* as it pertains to real estate has been interpreted very broadly by the courts. According to Reg. §1.1031(a)-1(c), no gain or loss is recognized if a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or a taxpayer exchanges investment property and cash for investment property of a like kind.

As amended by the TCJA, IRC Sec. 1031(a) provides that no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment (relinquished real property) if the relinquished real property is exchanged solely for real property of a like kind that is to be held either for productive use in a trade or business or for investment (replacement real property).

Under regulations published in November 2020, the term real property for purposes of IRC Sec. 1031 and its regulations is defined in a three-part test:

1. Is an asset treated as real property under state law? If it is, then it is real property for purposes of Section 1031,

2. If not so treated under state law, is the asset specifically described in the Regulations as an improvement to land or a structural component of an improvement to land, (land and improvements to land, unsevered natural products of land, and water and air space superjacent to land) [Reg. §1.1031(a)-3(a)(1)],

3. If not specifically described, is the asset treated as an improvement to land or a structural component of an improvement to land under the facts and circumstances test?

CAUTION: The Regulations' definition of real property is expressly limited to Section 1031. It creates no inference of application to the tax credit, cost recovery, cost capitalization, real estate investment trust, foreign investment withholding, or any other regime that looks to distinctions between real and personal property.

An interest in real property, including fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, or a similar interest, is real property for purposes of IRC Sec. 1031 and the proposed regulations [Reg. §1.1031(a)-3(a)(5)(i)

NEW DEVELOPMENT: Under the proposed regulations, local law definitions were *not* controlling for purposes of determining the meaning of the term *real property*. However, under the final regulations, property is real property if, on the date it is transferred in an exchange, the property is real property under the law of the State or local jurisdiction in which that property is located.

The term *improvements to land* means inherently permanent structures and the structural components of inherently permanent structures [Reg. §1.1031(a)-3(a)(2)(i)].

The term *inherently permanent structures* mean any building or other structure that is a distinct asset (essentially, the asset stands on its own) and is permanently affixed to real property and that will ordinarily remain affixed for an indefinite period [Reg. §1.1031(a)-3(a)(2)(ii)(A)].

NOTE: A *building* is any structure or edifice enclosing a space within its walls, and covered by a roof, the purpose of which is to provide shelter or housing, or to provide working, office, parking, display, or sales space (e.g., houses, apartments, office buildings, warehouses, barns, enclosed garages) [Reg. §1.1031(a)-3(a)(2)(ii)(B)].

The term *structural components* generally includes the following items: walls; partitions; doors; wiring; plumbing systems; central air conditioning and heating systems; pipes and ducts; elevators and escalators; floors; ceilings; permanent coverings of walls, floors, and ceilings; insulation; chimneys; fire suppression systems, including sprinkler systems and fire alarms; fire escapes; security systems; humidity control systems; and other similar property [Reg. §1.1031(a)-3(a)(2)(iii)(B)].

If property is not listed as an inherently permanent structure in Reg. §1.1031(a)-3(a)(2)(ii)(C), then the determination of whether the property is an inherently permanent structure is based on a five-factor test to establish qualification. Reg. 1.1031(a)-3(a)(2)(C) lists the following factors:

1. the manner in which the distinct asset is affixed to real property;
2. whether the distinct asset is designed to be removed or to remain in place,
3. the damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed,
4. any circumstances that suggest the expected period of affixation is not indefinite, and
5. the time and expense required to move the distinct asset.

Besides inherently permanent structures, the Regulations establish a third category of property that can be viewed as real property but must be analyzed separately: structural components of an inherently permanent structure. This four-part test provides that the following factors are relevant:

1. the manner, time, and expense of installing and removing the component,
2. whether the component is designed to be moved,
3. the damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed, and
4. whether the component is installed during construction of the inherently permanent structure.

Unsevered natural products of land, including growing crops, plants, and timber; mines; wells; and other natural deposits, generally are treated as real property. Natural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land [Reg. §1.1031(a)-3(a)(3)].

NOTE: Real property held by a developer primarily for sale (as opposed to held for productive use in a trade or business or for investment) *does not* qualify [IRC Sec. 1031(a)(2)]. Also, real property located in the U.S. and real property located outside the U.S. are not like-kind [IRC Sec. 1031(h)].

COMPUTING GAIN (OR LOSS)

When cash or not like-kind property is received in addition to like-kind property, gain is recognized to the lesser of total realized gain or the amount of boot received. The receipt of boot does not result in loss recognition if there is a realized loss [IRC Sec. 1031(b)].

If the only boot given is cash, any realized gain or loss *will not* be recognized by the party who pays the cash. However, if the boot given is appreciated (or depreciated) property, gain (or loss) is recognized to the extent of the difference between the adjusted basis and the FMV of the boot [Reg. §1.1031(d)-1(e)]. For this purpose, appreciated (or depreciated property) is defined as property for which the adjusted basis is not equal to the FMV.

EXAMPLE: Treatment of boot in property exchange

Alfera exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of $100,000 and a fair market value (FMV) of $110,000. The stock transferred has an adjusted basis of $40,000 and an FMV of $20,000. The real estate acquired has a FMV of $130,000.

Alfera is deemed to have received a $20,000 portion of the acquired real estate in exchange for the stock, since $20,000 is the FMV of the stock at the time of the exchange. A $20,000 loss is recognized on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by Alfera is:

Adjusted basis of real estate transferred	$ 100,000
Adjusted basis of stock transferred	40,000
	140,000
Less loss recognized on transfer of stock	(20,000)
Basis of real estate acquired upon the exchange	$ 120,000

Like-kind exchanges may involve properties burdened by debt. The assumption of debt by a transferee is treated by the transferor as boot. Whether a liability has been assumed is generally based upon the facts and circumstances. The taxpayer who assumes the debt gives boot, and the taxpayer whose debt is assumed receives boot.

To determine the boot given or received, the boot resulting from liabilities is netted for both parties. However, net boot given in the form of liabilities cannot reduce boot received in the form of cash or other property [Reg. §1.1031(d)-2, Ex. 2].

EXAMPLE: Determining boot resulting from liabilities

Donnie owns an apartment house in which has an adjusted basis of $500,000 and which is subject to a mortgage of $150,000. He transfers the apartment house to Jared, receiving in exchange $50,000 in cash and another apartment with an FMV of $600,000. The transfer to Jared is made subject to the $150,000 mortgage. Donnie realizes a gain of $300,000 on the exchange.

Value of like-kind property received	$ 600,000
Cash	50,000
Liabilities transferred	150,000
Total consideration received	800,000
Less adjusted basis of property	(500,000)
Total realized gain	$ 300,000

Under IRC Sec. 1031(b), Donnie will only recognize gain to the lesser of boot received ($200,000) or his realized gain of $300,000. Donnie received $200,000 of boot ($50,000 cash and $150,000 relief of liabilities) [Reg. §1.1031(d)-2].

PLANNING TIP: Since net boot given in the form of debt (i.e., liabilities assumed exceed liabilities surrendered) cannot offset the amount of boot received in the form of cash or property other than debt, practitioners should attempt to structure transactions so that the debt assumed is paid down before the exchange. This approach eliminates the gain attributable to the cash boot received (as the cash was instead used to pay down the mortgage prior to assumption) that cannot be offset by boot given in the form of an assumption of liabilities.

If property subject to Section 1245 depreciation recapture is transferred, recapture income is triggered to the extent of—

1. Gain recognized on the exchange determined without regard to Section 1245 recapture, plus

2. The FMV of like-kind property received that is not Section 1245 property and that is not taken into account under item (1) [IRC Sec. 1245(b)(4)].

When Section 1250 property is transferred, Section 1250 ordinary income recapture is recognized to the extent of—

1. Gain recognized on the exchange, or

2. The amount by which potential Section 1250 recapture income exceeds the FMV of the Section 1250 property received in the transaction.

Any Section 1250 recapture that is not recognized carries over to the property received in the like-kind exchange [IRC Secs. 1250(d)(4)(A) and (E)].

NOTE: For most real property placed in service after 1986, there is no Section 1250 recapture because straight line (SL) depreciation is required, and Section 1250 recapture is the excess of depreciation taken over the amount allowed using SL.

In a transaction where both Section 1245 and non-Section 1245 property are exchanged, the FMV of the non-Section 1245 property received is treated as boot. The property surrendered will be considered to have been sold at FMV. Exchange expenses reduce the amount of consideration received in a like-kind exchange and increase the basis of the like-kind property received.

BASIS AND HOLDING PERIOD

If an exchange does not qualify as nontaxable under IRC Sec. 1031, gain or loss is recognized, and the property's basis received in the exchange is its FMV. If the exchange qualifies for nonrecognition, the basis of property received is adjusted to reflect any deferred gain or loss [IRC Sec. 1031(d)].

The basis of like-kind property received in an IRC Sec. 1031 exchange is computed as follows:

Adjusted basis of like-kind property given

\+ FMV of boot given (if any)

\+ Gain recognized on like-kind property given (if any)

– FMV of boot received (if any)

= Basis of like-kind property received

EXAMPLE: Calculating basis in property

Assume the same facts as in the previous Example. Donnie's basis in the replacement apartment house will be $500,000 as computed below:

Adjusted basis in like-kind property given		$ 500,000
Plus:	Gain recognized on exchange	200,000
Less:	Cash received	(50,000)
	Liabilities attached to relinquished property	(150,000)
Adjusted basis in replacement apartment house		$ 500,000

The holding period of property received in an exchange begins with the date the taxpayer acquired the relinquished property. Therefore, the holding period of the relinquished property is added to the holding period of the replacement property. This rule only applies if the exchanged property was a capital asset or a Section 1231 asset [IRC Sec. 1223(1)]. The boot received has a new holding period (i.e., beginning on the date of exchange) rather than a carryover holding period.

Interaction with IRC 199A

A taxpayer's Section 199A deduction may be subject to a limitation based on Form W-2 wages and the UBIA (unadjusted basis immediately after acquisition) of qualified property. The term qualified property means, with respect to any trade or business (or aggregated trade or business) of an individual for a taxable year, tangible property of a character subject to the allowance for depreciation under IRC Sec. 167(a):

- Which is held by, and available for use in, the trade or business (or aggregated trade or business) at the close of the taxable year,

- Which is used at any point during the taxable year in the trade or business's (or aggregated trade or business's) production of QBI, and
- The depreciable period for which has not ended before the close of the individual's or RPE's taxable year [Reg. §1.199A-2].

The term *depreciable period* means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual and ending on the later of the date that is 10 years after such date [or the last day of the last full year in the applicable recovery period that would apply to the property under IRC Sec. 168(c) (e.g., 39-year MACRS)].

For purposes only of determining the depreciable period, the date on which replacement property that is of like kind to relinquished property was first placed in service by the individual is determined as follows:

For the portion of the individual's UBIA in the replacement property that does not exceed the individual's UBIA in the relinquished property, the date the replacement property was first placed in service by the individual is the date on which the relinquished property was first placed in service by the individual; and

For the portion of the individual's UBIA in the replacement property that exceeds the individual's UBIA in the relinquished property, that portion in the replacement property is treated as separate qualified property that the individual first placed in service on the date on which the replacement property was first placed in service by the individual.

Other qualified property received is treated as separate qualified property that the individual first placed in service on the date on which the other property was first placed in service by the individual.

EXAMPLE: Calculating UBIA

On January 5, 2014, Anna purchases Real Property X for $1 million and places it in service in her trade or business. Anna's basis in Real Property X is $1 million. Real Property X is qualified property for IRC Sec. 199A.

As of December 31, 2020, Anna's basis in Real Property X, as adjusted for depreciation deductions, is $821,550.

On January 15, 2021, Anna enters into a like-kind exchange under IRC Sec. 1031, in which Anna exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, but Real Property Y has a value of $1.5 million. Anna therefore adds $200,000 in cash to the exchange of Real Property X for Real Property Y.

On January 15, 2021, Anna places Real Property Y in service. As of January 15, 2020, Anna's basis in Real Property X, as adjusted for depreciation, is now $820,482.

Anna's UBIA in Real Property Y is $1.2 million ($1 million in UBIA from Real Property X plus $200,000 cash paid by Anna to acquire Real Property Y).

Because the UBIA of Real Property Y exceeds the UBIA of Real Property X, Real Property Y is treated as being two separate qualified properties. One property has a UBIA of $1 million (the portion of Anna's UBIA of $1.2 million in Real Property Y that does not exceed Anna's UBIA of $1 million in Real Property X) and it is first placed in service by Anna on January 5, 2014, which is the date on which Real Property X was first placed in service by Anna.

The other property has a UBIA of $200,000 (the portion of Anna's UBIA of $1.2 million in Real Property Y that exceeds Anna's UBIA of $1 million in Rea Property X) and it is first placed in service by Anna on January 15, 2021, which is the date on which Real Property Y was first placed in service by Anna.

DEPRECIATING PROPERTY ACQUIRED IN A LIKE-KIND EXCHANGE

Under the general rules of Reg. §1.168(i)-6, the IRS adopted a split basis concept for property acquired as part of an exchange. The replacement property has two components:

1. *Exchange basis amount.* The exchange basis amount is the adjusted basis of the relinquished property after subtracting the year of disposition depreciation [Regs. §1.168(i)-6(b)(7) and (9)], and

2. *Excess basis amount.* The taxpayer's additional depreciable basis (if any) in the replacement property over and above the amount of exchanged basis. The excess basis usually equals the amount of additional consideration paid (above and beyond the relinquished property) to acquire the replacement property. The excess basis amount is reduced by the amount of replacement property basis expensed under IRC Sec. 179 (if any) [Regs. 1.168(i)-6(b)(8) and (10)].

Exchange Basis Amount Depreciation

Generally, the exchange basis amount is depreciated over the remaining recovery period of a relinquished property using the same depreciation method, provided:

1. The replacement property has the same or shorter recovery period as the relinquished property, or

2. Has the same or faster depreciation method when compared to the relinquished party.

If a replacement property has either a longer recovery period or a slower depreciation method, a special exception applies. The remaining basis must be depreciated over the longer period that would have applied if the replacement property were placed in service when the relinquished property was placed in service.

EXAMPLE: Determining exchange basis amount depreciation

During January, Year 7, Homer exchanges an apartment building (27.5-year property) that he acquired in January, Year 1 for a commercial rental building (39-year property). Since the recovery period of the replacement property is longer than that of the relinquished property, the general rule does not apply. The replacement property will be depreciated as if he purchased 39-year property in Year 1, leaving the building to be depreciated over the remaining 33 years.

The excess basis amount is treated as a new asset placed in service in the year of the replacement. The *year of replacement* is the later of the tax year in which the replacement property was placed in service, or the tax year in which the relinquished property was disposed of. *Depreciation* of the excess basis amount is then calculated using the recovery period, depreciation method, and convention prescribed by

IRC Sec. 168 for the replacement property at the time of replacement. In addition, the excess basis amount can be taken into account for purposes of the Section 179 deduction (if otherwise eligible).

EXAMPLE: Treatment of excess basis amount

In July, Year 3, Judd exchanges his apartment building plus an additional $500,000 for a more expensive apartment building. The depreciation for the excess basis amount of $500,000 is treated as a new asset placed in service in July, Year 3.

Electing Out of the Regulations

Due to the complexity of these rules, the IRS has allowed taxpayers the option of electing out of the rules. If the election is made, the entire basis of the replacement asset (both exchange basis and the excess basis) is treated as newly acquired MACRS property and placed in service at the time of the replacement. For the purpose of the Section 179 expensing election, the regulations must be followed to determine the amount of excess basis, because the Section 179 election can only be made for the excess basis. The election is made on or before the due date (including extensions) of the taxpayer's return for the year of replacement. The election is made by typing or printing at the top of Form 4562 "ELECTION MADE UNDER REG. §1.168(i)- 6(i)" or in a manner provided on Form 4562 and its instructions.

VACATION HOME SAFE HARBOR

Gain deferral on like-kind exchanges under IRC Sec. 1031 is normally not available to homes unless held for the production of income or as investment property. A vacation home *does not* qualify for like-kind exchange, even if one of the motives in acquiring the home was the prospect of appreciation (*Moore v. Comm.*, TC Memo 2007-134). However, Rev. Proc. 2008-16 provides a safe harbor for when a second home will qualify as held either for productive use in a trade or business or for investment purposes.

The IRS will not challenge a property's qualification for Section 1031 treatment if it is—

1. *Relinquished property.* A dwelling unit that a taxpayer intends to be relinquished property in a Section 1031 exchange qualifies as property held for productive use in a trade or business or for investment if—

    a. The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the qualifying use period); and

    b. Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange—

        i. The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

        ii. The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

    For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

2. *Replacement property.* A dwelling unit that a taxpayer intends to be replacement property in a Section 1031 exchange qualifies as property held for productive use in a trade or business or for investment if—

    a. The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the qualifying use period); and

    b. Within the qualifying use period, in each of the two 12-month periods immediately after the exchange—

        i. The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

        ii. The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

    For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

RELATED-PARTY EXCHANGES

IRC Sec. 1031(f) provides a special rule for exchanges between related persons. A *related person* generally includes family members (including the taxpayer's spouse, siblings, ancestors, and lineal descendants), more than 50% controlled corporations and partnerships, and certain fiduciary relationships [IRC Secs. 267(b) and 707(b)(1)].

If related taxpayers exchange properties and either of them disposes of their property within two years, gain or loss originally not recognized under the Section 1031 rules will be recognized (i.e., IRC Sec. 1031 will not apply). Any gain or loss so recognized is considered in the year the disqualifying disposition occurs. However, losses are subject to the disallowance rules of IRC Sec. 267 for sales or exchanges between related parties.

A disposition during the two-year period will not trigger the unrecognized gain or loss if [IRC Sec. 1031(f)(2)]:

3. The disposition is after the death of the taxpayer or the related person;

4. The disposition is in a compulsory or involuntary conversion, as long as the exchange occurred before the threat or imminence of the conversion; or

5. It is established to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes [Ltr. Rul(s). 199926045 and 200706001].

DEFERRED EXCHANGES

Deferred exchanges (also called Starker exchanges or delayed exchanges) are the most common like-kind exchange used for real estate properties. They occur when the taxpayer relinquishes a property but has not yet acquired replacement property. Reg. §1.1031(k)-1 provides rules governing deferred exchanges. The two primary requirements to qualify a deferred exchange as a like-kind exchange are that—

1. The replacement property must be identified before the end of the 45-day identification period [IRC Sec. 1031(a)(3)(A)]; and

2. The identified property must be received before the expiration of the exchange period. The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer's return for the taxable year in which the transfer of the relinquished property occurs [Reg. §1.1031(k)-1(b)].

PLANNING TIP: Once replacement property has been identified, written notification should be given to all parties to the exchange. Further, be sure to extend a taxpayer's tax return for the taxable year in which relinquished property was transferred to allow as much time as possible to complete the exchange. Note there is no flexibility on these time lines—180 days means 180 days.

If a taxpayer receives money, notes or unlike property before a like-kind property is received, it is considered a sale and gain or loss is recognized (i.e., it is treated as a sale and subsequent purchase) [Reg. §1.1031(k)-1(f)]. The use of an intermediary (or accommodator) prevents this constructive receipt by the taxpayer, allowing an exchange to move ahead.

Replacement property under Reg. §1.1031(k)-1:

1. Property which would otherwise be like-kind property but that is identified outside the identification period or acquired outside of the exchange period is treated as boot.

2. Replacement property does not have to exist at the time an exchange property is transferred (e.g., build-to-suit project).

A taxpayer may identify more than one replacement property, despite only relinquishing a single property in the like-kind exchange. There are three rules governing the maximum number of replacement properties a taxpayer may identify [Reg. §1.1031(k)-1(c)(4)]:

1. Three properties without regard to the FMV of those properties, or the "3-property" rule;

2. Any number of properties as long as their aggregate FMV at the end of the identification period does not exceed 200% of the aggregate FMV of all of the relinquished properties, as of the day of relinquishment [Reg. §1.1031(k)-1(c)(4)(i)(B)]; or

3. Any number of replacement properties identified, but only if a taxpayer receives at least 95% of the aggregate FMV of all identified replacement properties before the end of the exchange period.

If a taxpayer identifies more replacement properties than allowed under the regulations, the taxpayer will be treated as if no replacement properties have been identified.

Same-Taxpayer Requirement

To satisfy the exchange requirements of IRC Sec. 1031, the same taxpayer that disposes of a relinquished property must acquire the replacement property. This may be a very difficult requirement to satisfy when lenders make demands on borrowers or when exchanges are being incorporated into an estate plan.

Spouses

If a relinquished property is titled as the spouse's separate property, then the replacement property should be acquired as the same spouse's separate property. When relinquished property is vested in a spouse as community property (or as tenants by the entirety in non-community property states), then the replacement property should also be acquired in the same manner.

Death of a Taxpayer

If a taxpayer dies during the exchange period, the taxpayer's estate (or trustee) should complete the exchange.

PLANNING TIP: If an exchange is not completed with the acquisition of replacement property by the executor of an estate (or trustee) of a trust of the taxpayer, then the tax liability that would have been due on the sale of the relinquished property becomes due on the taxpayer's final income tax return, or the estate (or trust) fiduciary income tax returns, as income in respect of a decedent.

Revocable living trusts or grantor trusts. A taxpayer may desire to acquire his replacement property in a revocable living trust or grantor trust for estate planning purposes. Alternatively, a lender may insist that a borrower not acquire interest in the replacement property in the name of their trust but rather in their individual name(s). Neither of these changes in ownership will affect exchange treatment under IRC Sec. 1031. Revocable living trusts or other grantor trusts are disregarded entities for federal tax purposes [Rev. Rul.(s). 92-105 and 88-103].

OBSERVATION: A taxpayer may also transfer a relinquished property to a grantor trust immediately prior to an exchange or transfer a replacement property to a grantor trust immediately after an exchange. The latter is very important in situations where a lender requires borrowers to have title to a property in their individual names when executing purchase loan documents.

Single-member limited liability companies (SMLLCs) are, by default, a disregarded entity and thus not considered separate entities for federal tax purposes.

PLANNING TIP: To avoid constructive receipt of cash or unlike property, in a typical deferred exchange, the taxpayer transfers property to the transferee (or a qualified intermediate) who promises to acquire replacement property and transfer it to the taxpayer.

NEW DEVELOPMENT: The Regulations provide that personal property that is incidental to replacement real property is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by a qualified intermediary are expressly limited [Reg. §1.1031(k)-1(g)(7)(iii)].

Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement real property [Reg. §1.1031(k)-1(g)(7)(iii)].

EXAMPLE: Treatment of personal property received incidental to a like-kind exchange of real property

In 2021, Barbara transfers to Charlie real property with a fair market value of $1.1 million and an adjusted basis of $400,000. Barbara's replacement property is an office building and, as a part of the exchange, Barbara also will acquire certain office furniture in the building that is not real property, which is industry practice in a transaction of this type. The fair market value of the real property Barbara will acquire is $1 million and the fair market value of the personal property is $100,000.

In a standard commercial transaction, the buyer of an office building typically also acquires some or all the office furniture in the building. The FMV of the personal property Barbara will acquire does not exceed 15% of the FMV of the office building Barbara will acquire. Accordingly, the personal property is incidental to the real property in the exchange and is disregarded in determining whether the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property are expressly limited.

Upon the receipt of the personal property, Barbara recognizes gain of $100,000 under IRC Sec. 1031(b): the lesser of the realized gain on the disposition of the relinquished property, $700,000, and the fair market value of the non-like-kind property Barbara acquired in the exchange, $100,000.

REVERSE EXCHANGES

Reverse exchange occurs when a taxpayer purchases a replacement property prior to the sale of the relinquished property.

NOTE: Even though the preamble to Reg. §1.1031(k)-1 specifically states that the deferred exchange rules do not apply to reverse exchanges, the IRS appears to have acquiesced in Rev. Proc. 2000-37 which provides guidance for these exchanges.

Rev. Proc. 2000-37 states that the IRS will not challenge the qualification of property as either replacement property or relinquished property, or the treatment of an accommodation party as property owner, for purposes of applying the non-recognition rules of IRC Sec. 1031 if the property is held in a qualified exchange accommodation arrangement (QEAA).

WHERE TO GO FOR MORE INFORMATION

- IRS Publication 544, *Sales and Other Dispositions of Assets*
- Form 8824, Like-Kind Exchanges, instructions
- IRS Reg. §1.199A-2, Determination of W-2 Wages and Unadjusted Basis Immediately after Acquisition of Qualified Property
- Like-Kind Exchanges – Real Estate Tax Tips at **www.irs.gov/businesses/small-businesses-self-employed/like-kind-exchanges-real-estate-tax-tips**

CHAPTER 39: ALTERNATIVE MINIMUM TAX (AMT)

Learning Objectives

Completion of this chapter will enable participants to—

- Explain the significance of alternative minimum taxable income (AMTI).
- Formulate and apply the applicable AMT exemptions.
- Compute alternative minimum tax (AMT) adjustments and preferences.

AMT OVERVIEW

Individual taxpayers are subject to two parallel tax systems: regular income tax and the alternative minimum tax (AMT). A taxpayer is liable for the larger of the taxes computed under each system. AMT applies to taxpayers who have certain types of income that receive favorable treatment, or who qualify for certain deductions, under the regular income tax law. These tax benefits can significantly reduce the regular tax of some taxpayers with higher economic incomes.

With the passage of the TCJA, AMT as an issue for US Taxpayers has been significantly reduced. With the now higher exemptions and the disallowance of certain itemized deductions, Taxpayers who fell into AMT every year, no longer will.

PLANNING TIP: While the standard deduction is disallowed under the AMT rules, the portion of the standard deduction attributable to a net qualified disaster loss is allowed for both regular tax and AMT purposes.

The special rules apply to—

- December 2019–December 2020 net disaster losses;
- 2018–2019 net disaster loss;
- Net disaster loss of an individual arising in the California wildfire area; or
- Net disaster loss of an individual arising in the Hurricane Harvey, Irma or Maria disaster areas.

The basic mechanism by which the AMT accomplishes its objective (of ensuring that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits) is by not treating favorably certain items that are treated favorably under the regular tax. Any item that is treated differently for AMT purposes than it is for regular tax purposes is termed a *tax preference* or an *adjustment*.

Adjustments differ from preferences in that adjustments involve a substitution of a special AMT treatment of an item for the regular tax treatment (e.g., depreciation), while a preference involves the addition of the difference between the special AMT treatment and the regular tax treatment (e.g., real estate taxes). Some (but not all) adjustments can be negative amounts (i.e., they may result in AMTI that is less than taxable income). Adjustments can be positive or negative, while tax preferences *cannot* be negative amounts.

To compensate for certain preferences and adjustments, a taxpayer is allowed an AMT exemption amount to reduce AMTI. The amount of the exemption is based on a taxpayer's filing status.

After the reduction for the exemption, AMT rates are applied to arrive at a tentative minimum tax. The taxpayer is entitled to reduce the tax by his AMT foreign tax credit. The AMT is the amount, if any, by which the tentative minimum tax exceeds the regular tax liability.

Capital gains tax rates apply if a taxpayer received qualified dividends, capital gain distributions, or reported long-term capital gains on Form 1040. AMT preferential tax rates for capital gains are the same as for regular tax. If capital gains tax rates *do not* apply, then 2020 AMT tax rates are—

1. 26% on the first $199,900 ($99,950 for MFS) of AMTI.
2. 28% on AMTI over $199,900 ($99,950 for MFS).

To account for timing differences, taxpayers can reduce the tax liability by any minimum tax credit (MTC) generated as a result of the deferrals. The use of the credit is limited to the extent the regular tax liability exceeds the AMT liability. Only deferral adjustments give rise to an MTC.

AMT Exemption Amounts for 2021 [IRC Sec. 55(d)(4)(A) and Rev. Proc. 2020-45				
Filing Status	**Permanent Exemption IRC Sec. 55(d) Amount (un-indexed)**	**Maximum Exemption (2021)**	**Reduced by 25% of AMTI over (2021)**	**Exemption Eliminated**
Single and HOH	$70,300	$, 73,600	$ 523,400	$817,800
MFJ or QW	$109,400	$ 114,600	$ 1,047,200	$1,505,600
MFS	$54,700	$ 57,600	523,600	$754,000

PERSONAL NONREFUNDABLE CREDITS

All the nonrefundable personal tax credits can be used to offset AMT liability as well as regular tax liability. The following nonrefundable credits are allowed against both regular tax and AMT:

1. Section 21 child and dependent care credit;
2. Section 22 credit for the elderly and disabled;
3. Section 23 adoption expense credit;
4. Section 24 child tax credit (nonrefundable portion only);
5. Section 25 credit for interest paid or accrued on certain home mortgages of low-income persons (the mortgage credit certificate [MCC] credit);

6. Section 25A credit for higher education expenses consisting of the American Opportunity Tax Credit (AOTC), except for 40% of the credit that may be treated as a refundable credit, and the Lifetime Learning credit;

7. Section 25B credit for elective deferrals and IRA contributions (the saver's credit);

8. Section 25C nonbusiness energy property credit;

9. Section 25D residential energy-efficient property (REEP) credit for qualified solar electric property, solar water heating property, small wind energy property, geothermal heat pump property, and fuel cell property; and

10. The nonbusiness portions of the Section 30B alternative motor vehicle credit, and the Section 30D qualified plug-in electric drive motor vehicles property and the 2-wheeled qualified plug-in electric vehicle credits.

MINIMUM TAX CREDIT (IRC SEC. 53)

Generally, the MTC is generated by temporary timing differences (deferral adjustments) in a prior year. The effects of permanent differences or preferences do not create a credit. Double taxation would occur without the MTC.

EXAMPLE: Effect of MTC

During Year 1, Nathan exercised a $20,000 option to purchase stock (a timing difference) worth $55,000 in M&M, Ltd. His AMTI is increased by $35,000, resulting in $9,100 of AMT. Assuming Nathan sold this stock during Year 5 for $45,000, which resulted in a regular tax gain of $25,000 and an AMT loss of $10,000 ($45,000 proceeds minus $55,000 AMT basis), AMT would be less than regular tax. There would be no benefit from the negative AMT adjustment. Without the MTC, Nathan would be taxed twice by paying AMT in Year 1 and regular tax in Year 5.

The law does not tie the use of an MTC created by a specific deferral item to the reversal of that item. The credit is available in the following tax year regardless of the status of the specific timing differences that gave rise to it.

EXAMPLE: Effect of carryforward MTC

Maya has a carryforward MTC from Year 1 in the amount of $50,000. In Year 2, Maya has a regular tax liability of $50,000 and an AMT liability of $45,000. Maya's use of the credit is limited to $5,000, the excess of the regular tax liability over the AMT liability. The remaining credit ($45,000) carries forward and will be used in future years.

COMMON AMT ISSUES AND CONCERNS

Large gains can create AMT. While long-term capital gain and qualified dividend rates are the same for both regular tax and AMT purposes, a large gain can reduce the AMT exclusion, which could cause other income to be subject to AMT.

Exercise of incentive stock options (ISOs) can result in a significant AMT liability. The AMT adjustment is the excess, if any, of the FMV (when the rights in the stock first became transferable or when these rights are no longer subject to substantial risk of forfeiture) over the amount paid for the stock. Increasing the AMT basis in stock by the amount of the AMT adjustment creates a difference between AMT basis and regular basis, which is resolved when the stock is sold. If exercised and sold in the same year, no adjustment is required [IRC Sec. 56(b)(3)].

Mortgage interest deduction is calculated differently for AMT purposes. While deductible for regular tax purposes, motor homes, RVs, and yachts *are not* qualified dwellings for AMT purposes [IRC Sec. 56(e)(2)]. Thus, the related interest expense *is not* deductible for AMT purposes. However, proceeds used to refinance an eligible mortgage, but not more than the outstanding balance of the qualifying eligible mortgage before it was refinanced, *are* deductible for AMT purposes (Rev. Rul. 2005-11).

PLANNING TIP: For tax years beginning before December 31, 2020, the regular-tax percentage-of-adjusted-gross-income (AGI) limit on medical expense deductions is 7.5%. For later tax years, it rises to 10%.

For tax years ending after 2018, the Code does not provide any special rule for calculating the percentage-of-AGI limitation on medical expense deductions for AMT purposes. Thus, for tax years ending after 2018, the same AGI floor will apply for both AMT and the regular tax purposes (i.e., 7.5% for tax years beginning before December 31, 2020 and 10% for later tax years).

So, no AMT medical expense adjustment is required for tax years ending after December 31, 2018.

Depreciation is calculated for AMT for three groups of property:

1. Section 1250 property (real property) that is not depreciated using the straight-line method.
2. Tangible property placed in service after 1986 and before 1999.
3. Property placed in service after 1998 that is depreciated for regular tax purposes using the 200% declining balance method (usually 3-, 5-, 7-, and 10-year property under MACRS).

Extra care should be exercised on the disposition of depreciable property. Generally, the difference between regular and AMT gain or loss is because the property may have a different adjusted basis for AMT.

PLANNING TIP: For taxpayers in the AMT exemption phase-out range, reducing income or accelerating deductions can reduce AMT. Anything that reduces adjusted gross income (AGI), such as retirement plan contributions or the expensing of equipment, can be helpful.

While tax-free sources of income can also help mitigate the cost of AMT, private activity bonds may generate income that is taxable for AMT purposes.

Practitioners should always review Form 6251 even if no AMT is owed. Just as with all other aspects of a software-created tax return, the practitioner needs to confirm the results are correct.

Practitioners should always print the completed Form 6251 in their preparer copy. The information on the form, although unnecessary to file for a year without AMT, may prove invaluable if the return is amended in the future.

ADJUSTMENTS AND PREFERENCES [IRC SEC(s). 56 AND 57]

Form **6251**

Department of the Treasury
Internal Revenue Service (99)

Alternative Minimum Tax—Individuals

► Go to *www.irs.gov/Form6251* for instructions and the latest information.
► Attach to Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074
2020
Attachment Sequence No. 32

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | **Your social security number**

Part I **Alternative Minimum Taxable Income** (See instructions for how to complete each line.)

1	Enter the amount from Form 1040 or 1040-SR, line 15, if more than zero. If Form 1040 or 1040-SR, line 15, is zero, subtract lines 12 and 13 of Form 1040 or 1040-SR from line 11 of Form 1040 or 1040-SR and enter the result here. (If less than zero, enter as a negative amount.)	1	
2a	If filing Schedule A (Form 1040), enter the taxes from Schedule A, line 7; otherwise, enter the amount from Form 1040 or 1040-SR, line 12	2a	
b	Tax refund from Schedule 1 (Form 1040), line 1 or line 8	2b	( )
c	Investment interest expense (difference between regular tax and AMT)	2c	
d	Depletion (difference between regular tax and AMT)	2d	
e	Net operating loss deduction from Schedule 1 (Form 1040), line 8. Enter as a positive amount	2e	
f	Alternative tax net operating loss deduction	2f	( )
g	Interest from specified private activity bonds exempt from the regular tax	2g	
h	Qualified small business stock, see instructions	2h	
i	Exercise of incentive stock options (excess of AMT income over regular tax income)	2i	
j	Estates and trusts (amount from Schedule K-1 (Form 1041), box 12, code A)	2j	
k	Disposition of property (difference between AMT and regular tax gain or loss)	2k	
l	Depreciation on assets placed in service after 1986 (difference between regular tax and AMT)	2l	
m	Passive activities (difference between AMT and regular tax income or loss)	2m	
n	Loss limitations (difference between AMT and regular tax income or loss)	2n	
o	Circulation costs (difference between regular tax and AMT)	2o	
p	Long-term contracts (difference between AMT and regular tax income)	2p	
q	Mining costs (difference between regular tax and AMT)	2q	
r	Research and experimental costs (difference between regular tax and AMT)	2r	
s	Income from certain installment sales before January 1, 1987	2s	( )
t	Intangible drilling costs preference	2t	
3	Other adjustments, including income-based related adjustments	3	
4	**Alternative minimum taxable income.** Combine lines 1 through 3. (If married filing separately and line 4 is more than $745,200, see instructions.)	4	

Part II **Alternative Minimum Tax (AMT)**

5 Exemption.

IF your filing status is . . .	**AND line 4 is not over . . .**	**THEN enter on line 5 . . .**
Single or head of household	$ 518,400	$ 72,900
Married filing jointly or qualifying widow(er)	1,036,800	113,400
Married filing separately	518,400	56,700

If line 4 is **over** the amount shown above for your filing status, see instructions. — **5**

6	Subtract line 5 from line 4. If more than zero, go to line 7. If zero or less, enter -0- here and on lines 7, 9, and 11, and go to line 10	6	
7	• If you are filing Form 2555, see instructions for the amount to enter. • If you reported capital gain distributions directly on Form 1040 or 1040-SR, line 7; you reported qualified dividends on Form 1040 or 1040-SR, line 3a; **or** you had a gain on both lines 15 and 16 of Schedule D (Form 1040) (as refigured for the AMT, if necessary), complete Part III on the back and enter the amount from line 40 here. • **All others:** If line 6 is $197,900 or less ($98,950 or less if married filing separately), multiply line 6 by 26% (0.26). Otherwise, multiply line 6 by 28% (0.28) and subtract $3,958 ($1,979 if married filing separately) from the result.	7	
8	Alternative minimum tax foreign tax credit (see instructions)	8	
9	Tentative minimum tax. Subtract line 8 from line 7	9	
10	Add Form 1040 or 1040-SR, line 16 (minus any tax from Form 4972), and Schedule 2 (Form 1040), line 2. Subtract from the result any foreign tax credit from Schedule 3 (Form 1040), line 1. If you used Schedule J to figure your tax on Form 1040 or 1040-SR, line 16, refigure that tax without using Schedule J before completing this line (see instructions)	10	
11	**AMT.** Subtract line 10 from line 9. If zero or less, enter -0-. Enter here and on Schedule 2 (Form 1040), line 1	11	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 13600G Form **6251** (2020)

WHERE TO GO FOR MORE INFORMATION

- IRS Form 6251, Alternative Minimum Tax—Individuals and instructions
- IRS Form 8801, Credit for Prior Year Minimum Tax—Individuals, Estates, and Trusts and instructions.

CHAPTER 40: IRC SEC. 199A—QUALIFIED BUSINESS INCOME DEDUCTION (QBID)

Learning Objectives

Completion of this chapter will enable participants to—

- Calculate the qualified business income deduction (QBID) under IRC Sec. 199A.
- Identify a specified service trade or business (SSTB).
- Analyze the aggregation election under Reg. §1.199A-4.

OVERVIEW

This chapter covers the rules for determining the qualified business income deduction (QBID).

For tax years beginning after 2017 and before 2026, individual taxpayers (and certain trusts and estates) may be entitled to a deduction of up to 20% of their QBI from a trade or business, including income from a pass-through entity, but not from a C corporation, plus 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

The deduction is subject to multiple limitations, depending on a taxpayer's taxable income, and may include the type of trade or business, the amount of W-2 wages paid by the trade or business, and the unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business.

The deduction applies only for income tax purposes. The deduction isn't considered in determining adjusted gross income. The deduction can be taken in addition to the standard or itemized deductions.

> **IRS GUIDANCE:** An IRS small business (self-employed) memorandum (SBSE-04-1219-0054) issued in late 2019 concludes that the QBID will not be allowed on a substitute for return (SFR) prepared under IRC Sec. 6020(b). The guidance does note, however, that if a taxpayer subsequently files a delinquent tax return that includes a QBI deduction, the Service will consider the deduction following the same policies for other items included on the filed return.

TRADE OR BUSINESS

General Rule

For purposes of IRC Sec. 199A, a taxpayer's qualified trades and businesses include Section 162 trades or businesses, other than trades or businesses conducted through a C corporation, W-2 wages earned as an employee, and specified service trades or businesses (SSTBs) (as discussed later).

In general, to be engaged in a trade or business, a taxpayer must be involved in an activity with continuity and regularity, and the primary purpose for engaging in the activity is for income or profit.

Reg. §1.199A-1 defines a relevant pass-through entity (RPE) as a partnership (other than a publicly traded partnership) or an S corporation, that is owned, directly or indirectly, by at least one individual, estate, or trust. If a taxpayer owns an interest in an RPE, the trade or business determination is made at that entity's level.

Real Property Activities

The ownership and rental of real property may constitute a trade or business. Certain commonly controlled property qualifies as a trade or business for purposes of the Section 199A deduction.

Per Reg. §1.199A-1, renting or licensing tangible or intangible property (rental activity) that does not rise to the level of a Section 162 trade or business is nevertheless treated as a trade or business for purposes of IRC Sec. 199A, if the property is rented or licensed to a trade or business conducted by the individual (or an RPE) which is commonly controlled under Reg. §1.199A-4(b)(1)(i) [regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under Reg. §1.199A-4(b)(1)].

The common controlled rule is met if the same person or group of persons, directly or by attribution under IRC Sec(s). 267(b) or 707(b), owns 50% or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50% or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50% or more of the capital or profits in the partnership.

EXAMPLE: Rental activity treated as a trade or business for purposes of IRC Sec. 199A

Gregory owns 80% of the stock in S1, an S corporation, and 80% of LLC1 and LLC2, each of which is a partnership for federal tax purposes.

- LLC1 manufactures and supplies all the widgets sold by LLC2.
- LLC2 operates a retail store that sells LLC1's widgets.
- S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store.
- Gregory owns 50% or more of the stock of S1 and 50% or more of LLC1 and LLC2.

The rental activity of S1 will be treated as a trade or business for purposes of IRC Sec. 199A.

Alternatively, Rev. Proc. 2019-38 provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business for purposes of the QBID. If the safe harbor requirements are met, a real estate enterprise will be treated as a trade or business for purposes of applying the regulations under IRC Sec. 199A. Relevant passthrough entities (RPEs) may also use this safe harbor.

A *rental real estate enterprise* is defined as an interest in real property held for production of rents and may consist of an interest in multiple properties. An individual or RPE must hold the interest directly or through an entity disregarded as an entity separate from its owner. Taxpayers must either treat each property held for production of rents as a separate enterprise or treat all similar properties held for production of rents as a single enterprise. Commercial and residential real estate *may not* be part of the same enterprise.

PLANNING TIP: Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor, the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor. Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances.

However, a taxpayer or RPE that chooses to treat its interest in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar commercial or all similar residential properties as a single rental real estate enterprise in a future year.

An interest in mixed-use property may be treated as a single rental real estate enterprise or may be bifurcated into separate residential and commercial interests. *Mixed-use property* is defined as a single building that combines residential and commercial units (e.g., retail and restaurant space on the first floor and residential space on remaining three floors).

An interest in mixed-use property, if treated as a single rental real estate enterprise, may not be treated as part of the same enterprise as other residential, commercial, or mixed-use property. Solely for purposes of IRC Sec. 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

1. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise.

PLANNING TIP: If a rental real estate enterprise contains more than one property, this requirement may be satisfied if income and expense information statements for each property are maintained and then consolidated.

2. For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed (see discussion below) per year with respect to the rental real estate enterprise. For rental real estate enterprises that have been in existence for at least four years, in any three of the five consecutive taxable years that end with the taxable year, 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and

3. The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following:

    a. hours of all services performed,

    b. description of all services performed,

    c. dates on which such services were performed; and

    d. whom performed the services.

PLANNING TIP: If services with respect to the rental real estate enterprise are performed by employees or independent contractors, the taxpayer may provide a description of the rental services performed by such employee or independent contractor, the amount of time such employee or independent contractor generally spends performing such services for the enterprise, and time, wage, or payment records for such employee or independent contractor.

4. The taxpayer or RPE attaches a statement to a timely filed original return for each taxable year in which the taxpayer or RPE relies on the safe harbor. An individual or RPE with more than one rental real estate enterprise relying on this safe harbor may submit a single statement but the statement must list the required information separately for each rental real estate enterprise. The statement must include the following information:

    a. A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise,

    b. A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and

    c. A representation that the requirements of Rev. Proc. 2019-38 have been satisfied.

Rental services include:

1. Advertising to rent or lease the real estate.
2. Negotiating and executing leases.
3. Verifying information contained in prospective tenant applications.
4. Collection of rent.
5. Daily operation, maintenance, and repair of the property, including the purchase of materials and supplies.
6. Management of the real estate.
7. Supervision of employees and independent contractors.

Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. However, the term *rental services* <u>does not</u> include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; improving property under Reg. §1.263(a)-3(d); or hours spent traveling to and from the real estate.

Certain real estate may not be included in a rental real estate enterprise and are not eligible for the safe harbor, including:

1. Real estate used by a taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under IRC Sec. 280A (e.g., home office).

2. Real estate rented or leased under a triple net lease. For this purpose, a triple net lease includes a lease agreement that requires a tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.

3. Real estate rented to a trade or business conducted by a taxpayer or an RPE which is commonly controlled under Reg. §1.199A-4(b)(1).

4. The entire rental real estate interest if any portion of the interest is treated as an SSTB under Reg. §1.199A-5(c)(2).

Lastly, rental real estate that is not commonly controlled real property and does not meet the requirements of the safe harbor may still be treated as a trade or business for purposes of the QBID if it otherwise can meet the definition of a trade or business in Reg. §1.199A-1(b)(14). It can be difficult to determine whether renting real estate is a trade or business or merely an activity engaged in for profit because the term tr*ade or business* is not defined in IRC Sec. 162.

To be engaged in a trade or business, a taxpayer must be involved in an activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

In determining whether a rental real estate activity is a Section 162 trade or business, relevant factors might include, but are not limited to—

Type of property (e.g., commercial real property versus residential property).

1. Number of properties rented,

2. Owner's or the owner's agent's day-to-day involvement,

3. Types and significance of any ancillary services provided under the lease, and

4. Terms of the lease (for example, a net lease versus a traditional lease, or a short-term lease versus a long-term lease).

Because this is a facts-and-circumstances test, several court cases have addressed whether the rental of real estate is a trade or business.

In *Fackler* (45 BTA 708), the taxpayer owned a six-story apartment building. The Court found that managing the building involved continuous activity (such as repairs and furnishing basic utilities), employing labor, and buying materials. So, it was a trade or business, regardless of the fact that the taxpayer, a full-time lawyer, visited the property only once or twice a month for one or two hours each time.

In *Murtaugh* (TC Memo 1997-319), the taxpayer was found to be engaged in a trade or business when he purchased and rented two timeshares. The court noted that the taxpayer researched various locations and chose the timeshares based on where he thought he could turn a profit, rather than his personal preferences for a vacation spot. Although the taxpayer did not perform many activities with respect to the timeshares personally, the court found that the seller of the timeshare was acting as the taxpayer's agent when it provided advertising, guest registration, housekeeping, and inventory replenishment in exchange for 40% of the rent receipts on the property. Those activities were sufficient to rise to the level of a trade or business.

Conversely, in *Grier* [45 AFTR 1975 (120 F. Supp. 395), (DC-CT)], the taxpayer inherited a home that was leased to a tenant. The existing tenant continued to occupy the residence and pay rent until the house was sold 14 years later. While the taxpayer did pay for upkeep and repairs during that time (generally after receiving and approving estimates provided by the tenant), the court ruled that the house was a capital asset in the taxpayer's hands because it did not require regular and continuous activity to manage.

COMPUTATIONAL RULES AND LIMITATIONS

Taxable Income

The amount of a Section 199A deduction is the lesser of—

1. The combined qualified business income of a taxpayer for the tax year, or

2. The sum of 20% of the excess (if any) of a taxpayer's taxable income for the tax year (determined without regard to this deduction) over the taxpayer's net capital gain for the tax year.

PLANNING TIP: Net capital gain means net capital gain as defined in IRC Sec. 1222(11) plus qualified dividend income. Under IRC Sec. 1222(11), net capital gain is the excess of net long-term capital gain for a taxable year over net short-term capital loss for such year.

EXAMPLE: Computing taxable income

Ann, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. Ann has no capital gains or losses.

After allowable deductions not relating to the business, Ann's total taxable income for 2020 is $81,000. Ann's Section 199A deduction for 2020 is equal to $16,200, the lesser of 20% of Ann's QBI from the business ($100,000 × 20% = $20,000) and 20% of Ann's total taxable income for the taxable year ($81,000 × 20% = $16,200).

Variation: Assume the same facts, except Ann also has $7,000 in net capital gain for 2020 and that, after allowable deductions not relating to the business, Ann's taxable income for 2020 is $74,000. Ann's taxable income minus net capital gain is $67,000 ($74,000 – $7,000).

Ann's Section 199A deduction is equal to $13,400, the lesser of 20% of Ann's QBI from the business ($100,000 × 20% = $20,000) and 20% of Ann's total taxable income minus net capital gain for the taxable year ($67,000 × 20% = $13,400).

A taxpayer's combined qualified business income for a tax year is equal to—

1. The sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer, plus

2. 20% of the aggregate amount of the qualified REIT (real estate investment trust) dividends and qualified PTP (publicly traded partnership) income of the taxpayer for the tax year.

The term *qualified business income* (QBI) means the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of a taxpayer, provided the other requirements of IRC Sec. 199A are satisfied (e.g., the exclusion of income not effectively connected with a United States trade or business). Certain items are not considered as a qualified item of income, gain, deduction, or loss, including (not an exhaustive list):

1. Short-term or long-term capital gains or losses.
2. Interest or dividend income.
3. Qualified REIT dividends (see discussion below).
4. Qualified PTP income (see discussion below).
5. Reasonable compensation from an S corporation.
6. Guaranteed payments from a partnership.

REGULATION 1.199A-3(b)(1)(iv)(A): Final regulations issued in 2020 clarify that previously disallowed losses or deductions allowed in the taxable year generally are considered for purposes of computing QBI (to the extent the disallowed loss or deduction is otherwise allowed by IRC Sec. 199A).

Under the final regulations, the previously disallowed losses include, but are not limited to, losses disallowed under IRC Sec(s). 461(l), 465, 469, 704(d), and 1366(d).

The losses are used in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and are treated as losses from a separate trade or business. To the extent such losses relate to a PTP, they must be treated as a loss from a separate PTP in the taxable year the losses are considered. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 [including under IRC Sec(s). 465, 469, 704(d), and 1366(d)], are not considered in a subsequent taxable year for purposes of computing QBI.

Partial Allowance

If a loss or deduction attributable to a trade or business is only partially allowed during the taxable year in which incurred, only the portion of the allowed loss or deduction that is attributable to QBI will be considered in determining QBI from the trade or business in the year the loss or deduction is incurred.

The portion of the allowed loss or deduction attributable to QBI is determined by multiplying the total amount of the allowed loss by a fraction, the numerator of which is the portion of the total loss incurred during the taxable year that is attributable to QBI and the denominator of which is the amount of the total loss incurred during the taxable year.

Specified Service Trades or Businesses

If a disallowed loss or deduction is attributable to a specified service trade or business (SSTB), whether an individual has taxable income at or below the threshold amount, within the phase-in range, or in excess of the phase-in range is determined in the year the loss or deduction is incurred.

If the individual's taxable income is at or below the threshold amount in the year the loss or deduction is incurred, the entire disallowed loss or deduction (e.g., Section 469 passive activity loss) must be considered.

If the individual's taxable income is within the phase-in range, then only the *applicable percentage*, (as discussed below) of the disallowed loss or deduction is considered.

If the individual's taxable income exceeds the phase-in range, none of the disallowed loss or deduction will be considered.

EXAMPLE: Determining effects of income/loss attributable to QBI

Auria is an unmarried individual and a 50% owner of Golf Equipment Partners, an entity classified as a partnership for Federal income tax purposes.

In 2021, Auria's allocable share of loss from Golf Equipment Partners is $100,000 of which $80,000 is negative QBI. Under IRC Sec. 465 (the at-risk basis rules), $60,000 of the allocable loss is allowed when determining Auria's taxable income. She has no other previously disallowed losses under IRC Sec. 465 or any other provision of the Code for 2021 or prior years.

Because 80% of Auria's allocable loss is attributable to QBI ($80,000 ÷ $100,000), Auria will reduce the amount she considers in determining QBI proportionately.

She will include $48,000 of the allowed loss in negative QBI (80% of $60,000) in determining her Section 199A deduction in 2021.

The remaining $32,000 of negative QBI is treated as negative QBI from a separate trade or business for purposes of computing the Section 199A deduction in the future tax year the loss is considered in determining taxable income.

EXAMPLE: Determining effects of SSTB income/loss on QBI treatment

Bob is an unmarried individual and a 50% owner of Ice Skate Consultants, an entity classified as a partnership for Federal income tax purposes. After allowable deductions (other than the Section 199A deduction), Bob's taxable income for 2021 is $184,900.

In 2021, Ice Skates Consultants has a single trade or business that is an SSTB. Bob's allocable share of loss is $100,000, all of which is suspended under IRC Sec. 465 (the at-risk basis rules). Bob's allocable share of negative QBI is also $100,000. Bob has no other previously disallowed losses under IRC Sec. 465 or any other provision of the Code for 2021 or prior years.

Because the entire loss is suspended, none of the negative QBI is considered in determining Bob's Section 199A deduction for 2021. Further, because the negative QBI is from an SSTB and Bob's taxable income before the Section 199A deduction is within the phase-in range, Bob must determine the applicable percentage of the negative QBI that must be considered in the year that the loss is considered in determining taxable income.

His applicable percentage is 100% reduced by 40% [the percentage equal to the amount that Bob's taxable income for the taxable year exceeds Bob's threshold amount ($20,000 = $184,900 – $164,900) ÷ $50,000]. Thus, Bob's applicable percentage is 60%.

Therefore, he will have $60,000 (60% of $100,000) of negative QBI from a separate trade or business to be applied proportionately to QBI in the year(s) the loss is considered in determining taxable income, regardless of the amount of taxable income and how the rules under Reg. §1.199A-5 (the SSTB regulation) apply in the year the loss is considered in determining taxable income.

Per Reg. §1.199A-3, for Section 199A purposes only, deductions such as the deductible portion of the tax on self-employment income, the self-employed health insurance deduction, and contributions to qualified retirement plans are considered attributable to a trade or business to the extent an individual's gross income from the trade or business is considered in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.

EXAMPLE: Effects of SE Tax, retirement plan contributions, and health insurance premiums on QBI

David is a software developer and a Schedule C taxpayer. David's (line 31) net profit from his Schedule C is $125,667. For the tax year, David is deducting $4,807 in self-employment tax and $43,172 in retirement plan contributions [solo 401(k) plan contribution]. His QBI for the Schedule C activity is—

Principle business or profession	Form/Schedule	Unit
Consulting / software developer	C	1

1.	Schedule C, Line 31, Net profit or (loss)	**1.**	125,667
	Additions for qualified business income:		
2.	Form 4797, Ordinary income	**2.**	
	Prior to TCJA suspended losses allowed:		
3.	Passive suspended losses	**3.**	
4.	At-Risk suspended losses	**4.**	
5.	Section 179 carryover	**5.**	
6.	Total additions to net profit or (loss). Add lines 2 through 5.	**6.**	
	Subtractions for qualified business income		
7.	Form 4797, Ordinary loss (includes share of Net section 1231 losses)	**7.**	
8.	Deductible portion of self-employment taxes	**8.**	4,807
9.	Self-employed SEP, SIMPLE, and qualified plans	**9.**	43,172
10.	Self-employed health insurance deduction	**10.**	
11.	Passive suspended to next year	**11.**	
12.	At-Risk suspended to next year	**12.**	
13.	Total subtraction to net profit or (loss). Add lines 7 through 12.	**13.**	47,979
14.	Qualified business income for this activity. Line 1 plus line 6 less line 13.	**14.**	77,688

Variation: Assume instead that for the tax year, David is deducting $4,807 in self-employment tax, $9,000 in self-employed health insurance premiums, and $43,172 in retirement plan contributions [solo 401(k) plan contribution]. His QBI for the Schedule C would be reduced to $68,688.

> **NOTE:** IRS guidance here is similarly disheartening for 2% S corporation shareholder-employees. Health insurance premiums paid by an S corporation for 2% shareholders reduce qualified business income (QBI) at the entity level by reducing the ordinary income used to compute allocable QBI. Per the IRS, the self-employed health insurance deduction under IRC Sec. 162(l) is considered attributable to a trade or business for purposes of IRC Sec. 199A and will be a deduction in determining QBI. This may result in QBI being reduced at both the entity and the shareholder level.

Wage and Basis

Generally, the deductible amount for a qualified trade or business is the lesser of—

1. 20% of the taxpayer's qualified business income from the qualified trade or business, or
2. The greater of—
    a. 50% of the W-2 wages relating to the qualified trade or business, or
    b. The sum of 25% of the W-2 wages relating to the qualified trade or business and 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all qualified property.

However, the wage and basis limitation doesn't apply for taxpayers below the threshold amount, as indexed for inflation. The thresholds rise to $164,900 ($329,800 for joint filers) for 2021. The threshold amount is a taxpayer's taxable income without regard to the Section 199A deduction. IRC Sec. 199A(b)(2)(B) provides limitations on the QBI deduction based on W-2 wages paid with respect to each trade or business.

Wages must be reported on returns (e.g., Forms W-3 and W-2) filed with the Social Security Administration (SSA) on a timely basis. For this purpose, wages are the IRC Sec. 3401(a) definition plus total elective deferrals plus compensation deferred under IRC Sec. 457 plus designated Roth contributions. Wages include those paid to any officer of a corporation (including officers of an S corporation) and any common law employee [IRC Sec. 3121(d)(1) and (2)].

Rev. Proc. 2019-11 provides three methods for calculating W-2 wages for purposes of the Section 199A deduction. These include the unmodified box method, the modified box 1 method, and the tracking wages method.

Under the unmodified box method, W-2 wages are calculated by taking, without modification, the lesser of—

1. The total entries in Box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer; or
2. The total entries in Box 5 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

Under the modified box 1 method, a taxpayer makes modifications to the total entries in box 1 of Forms W-2 filed with respect to employees of the taxpayer. W-2 wages under this method are calculated as follows:

1. Total the amounts in box 1 of all Forms W-2 filed with SSA by the taxpayer with respect to employees of the taxpayer for employment by the taxpayer.

2. Subtract from that total amounts included in box 1 of Forms W-2 that are not wages for Federal income tax withholding purposes, including amounts that are treated as wages for purposes of income tax withholding under IRC Sec. 3402(o), and

3. Add to that amount the total of the amounts that are reported in box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and that are properly coded D, E, F, G, and S.

Under the tracking wages method, a taxpayer tracks total wages subject to federal income tax withholding and makes appropriate modifications. W-2 wages under this method are calculated as follows:

1. Total the amounts of wages subject to federal income tax withholding paid to employees of the taxpayer for employment by the taxpayer and that are reported on Forms W-2 filed with SSA by the taxpayer for the calendar year; plus

2. The total of the amounts that are reported in box 12 of Forms W-2 with respect to employees of the taxpayer for employment by the taxpayer and are properly coded D, E, F, G, and S.

The Forms W-2 used in determining the amount of Form W-2 wages are those that are issued for the calendar year ending during the taxpayer's taxable year for wages paid to employees (or former employees) of the person for employment by the person.

Only W-2 wages which are properly allocable to QBI may be considered in computing the W-2 wage limitations. W-2 wages are properly allocable to QBI if the associated wage expense is considered in computing QBI. In the case of an RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code, including Subchapters K and S.

IRC Sec. 199A(b)(2)(B) provides limitations on the QBI deduction based on the unadjusted basis immediately after acquisition (UBIA) of qualified property in a trade or business. For any trade or business of an individual or RPE for a taxable year, UBIA includes tangible property of a character subject to the allowance for depreciation under IRC Sec. 167(a):

1. Which is held by, and available for use in the trade or business at the close of the taxable year,

2. Which is used at any point during the taxable year in the trade or business's production of QBI, and

3. The depreciable period that has not ended before the close of the individual's or RPE's taxable year.

The term *depreciable period* means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by an individual or RPE and ending on the later of—

1. The date that is 10 years after such date, or

2. The last day of the last full year in the applicable recovery period that would apply to the property (e.g., 39-year MACRS).

The term *UBIA* means the basis on the placed-in-service date of property (i.e., do not reduce for depreciation or tax credits).

EXAMPLE: Difference between basis and UBIA

On January 5, Year 1, Allan purchases Property X for $1 million and places it in service of his trade or business. Allan's basis in Property X under IRC Sec. 1012 is $1 million. Property X is qualified property.

As of December 31, Year 6, Allan's basis in Property X, as adjusted for depreciation deductions, is $821,550. Allan's UBIA of Property X is its original $1 million cost basis which *is not* reduced by depreciation deductions.

The final regulations provide each partner's share of the UBIA of qualified property is determined in accordance with how depreciation is allocated for IRC Sec. 704(b) book purposes under Reg. §1.704-1(b)(2)(iv)(g) on the last day of the taxable year.

For S corporations, UBIA is allocated proportionate to the ratio of shares held by a shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation.

SSTB Limitation

For Section 199A purposes, a *qualified trade or business* is any trade or business other than a specified service trade or business (SSTB) or the business of performing services as an employee [IRC Sec. 199A(d)(1)]. However, if a taxpayer's taxable income is less than the sum of the $164,900 ($329,800 in the case of a joint return) threshold amount, plus $50,000 ($100,000 in the case of a joint return), the exclusion for SSTBs of the taxpayer for the tax year *will not* apply (all amounts are indexed for inflation). Thresholds rise to $164,900 ($329,800 for joint filers) in 2021.

The SSTB limitation applies to any direct or indirect individual owners of a business, regardless of whether the owner participates in the business or not (i.e., it makes no difference whether the owner is passive, active or a material participant in the activity).

There are 13 specific SSTBs listed in Reg. §1.199A-5(b)(1):

1. Health (e.g., physicians, dentists, and veterinarians).
2. Law (e.g., lawyers, paralegals, and mediators).
3. Accounting (e.g., accountants and tax return preparers).
4. Actuarial science.
5. Performing arts (e.g., actors, singers, entertainers).
6. Consulting.

PLANNING TIP: Reg. §1.199A-5(b)(2)(vii) provides that services within the fields of architecture and engineering are not treated as consulting services for purposes of IRC Sec. 199A.

7. Athletics (e.g., athletes and coaches).
8. Financial services (e.g., professionals advising clients with respect to finances).

9. Brokerage services. This includes services provided by stockbrokers and other similar professionals but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

10. Investing and investment management (e.g., professionals providing advice with respect to buying and selling investments).

11. Trading (e.g., trader in securities).

12. Dealing in securities, partnership interests or commodities.

13. Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

For this purpose, "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners" means any trade or business that consists of any of the following (or any combination thereof) [Reg. §1.199A-5(b)(2)(xiv)]:

1. A trade or business in which a person receives fees, compensation, or other income for endorsing products or services,

2. A trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity, or

3. Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

EXAMPLE: Determining whether income is from an SSTB activity

Lynda is a well-known chef and the sole owner of multiple restaurants, each of which is owned in a disregarded entity. Due to Lynda's skill and reputation as a chef, Lynda receives an endorsement fee of $500,000 for the use of Lynda's name on a line of cooking utensils and cookware.

Lynda is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, Lynda is also in the trade or business of receiving endorsement income. Lynda's trade or business consisting of the receipt of the endorsement fee for Lynda's skill and/or reputation is an SSTB.

Under the *de minimis* rule, for a trade or business with gross receipts of $25 million dollars or less for the taxable year, a trade or business *is not* an SSTB if less than 10% (5% for taxpayers with gross receipts in excess of $25 million) of the gross receipts of the trade or business are attributable to the performance of services.

EXAMPLE: Trade or business SSTB income exceeds 10% of gross receipts

Landscape LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings. The landscape design services include advice on the selection and placement of trees, shrubs, and flowers and are the performance of services in the field of consulting.

Landscape LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Landscape LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business for IRS Sec(s). 162 and 199A.

Landscape LLC has gross receipts of $2 million. $250,000 of the gross receipts is attributable to the landscape design services, an SSTB. Because the gross receipts from the consulting services exceed 10% of Landscape LLC's total gross receipts, the entirety of Landscape LLC's trade or business is considered an SSTB.

Variation: If Landscape LLC accounts for the two separate trade or business activities by keeping separate books and records for each, it would have both SSTB and non-SSTB separate activities that would have separate activity schedules and separate reporting for the Section 199A deduction.

EXAMPLE: Trade or business SSTB income *does not* exceed 10% of gross receipts

Animal Care LLC provides veterinarian services performed by licensed staff and develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are the performance of services in the field of health.

Animal Care LLC separately invoices for its veterinarian services and the sale of its organic dog food. Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products. Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for IRC Sec(s). 162 and 199A.

Animal Care LLC has gross receipts of $3 million. $1 million of the gross receipts is attributable to veterinary services, an SSTB. Although the gross receipts from the services in the field of health exceed 10% of Animal Care LLC's total gross receipts, the dog food development and sales business are not considered an SSTB due to the fact that the veterinary practice and the dog food development and sales are separate trades or businesses under IRC Sec. 162.

Under the services or property provided to an SSTB rule, the portion of a trade or business of providing property or services to a 50% or more commonly owned SSTB [IRC Sec(s). 267(b) and 707(b)] is treated as a part of the SSTB.

EXAMPLE: Treatment of portion of a trade or business providing property or services to a 50% or more commonly owned SSTB

Law Firm is a partnership that provides legal services to clients, owns its own office building, and employs its own administrative staff. Law Firm divides into three partnerships:

- Partnership 1 performs legal services to clients.
- Partnership 2 owns the office building and rents the entire building to Partnership 1.

- Partnership 3 employs the administrative staff, and through a contract with Partnership 1, provides administrative services to Partnership 1 in exchange for fees.

All three of the partnerships are owned by the same people (the original owners of Law Firm).

Because Partnership 2 provides all its property to Partnership 1, and Partnership 3 provides all its services to Partnership 1, Partnerships 2 and 3 will each be treated as an SSTB under Reg. §1.199A-5.

Variation: Assume the same facts, except that Partnership 2, which owns the office building, rents 50% of the building to Partnership 1, which provides legal services, and the other 50% to various unrelated third-party tenants.

Because Partnership 2 is owned by the same people as Partnership 1, the portion of Partnership 2's leasing activity related to the lease of the building to Partnership 1 will be treated as a separate SSTB. The remaining 50% of Partnership 2's leasing activity will not be treated as an SSTB.

The SSTB limitation also applies to income earned from a publicly traded partnership (PTP).

Reg. §1.199A-1 Ordering Rules

An individual with taxable income for the taxable year that exceeds the threshold amount uses the following computational rules (in this order):

1. *SSTB exclusion.* If an individual's taxable income is within the phase-in range (up to $214,900 or $429,800 in 2021) then only the applicable percentage of QBI, W-2 wages, and UBIA are used.

2. *Aggregated trade or business.* If an individual (or RPE) chooses to aggregate trades or businesses under the rules of Reg. §1.199A-4, they must combine the QBI, W-2 wages, and UBIA of qualified property of each trade or business aggregated prior to applying the W-2 wages and UBIA of qualified property limitations.

3. *Netting.* If an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not considered and are not carried over to a subsequent year.

4. *Carryover.* If an individual's QBI from all trades or businesses combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable year of the individual for IRC Sec. 199A only. The W-2 wages and UBIA of qualified property from the trades or businesses which produced net negative QBI are not considered and are not carried over to the subsequent year.

Reduction amount means, with respect to any taxable year, the excess amount multiplied by the ratio that taxable income of an individual for a taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For this purpose, the excess amount is the amount by which 20% of QBI exceeds the greater of 50% of W-2 wages or the sum of 25% of W-2 wages plus 2.5% of the UBIA of qualified property.

EXAMPLE: Effect on QBI of taxable income exceeding threshold amounts

Scenario 1: Elvis is single and is a 30% owner of an LLC (partnership). During the year, the LLC has a single trade or business and reported QBI of $3 million. The LLC paid total W-2 wages of $1 million, and its total UBIA of qualified property is $100,000. Elvis is allocated 30% of all items of the partnership. For the taxable year, he reports $900,000 of QBI from the LLC, $300,000 in W-2 wages, and $30,000 UBIA.

After allowable deductions unrelated to the LLC, Elvis's taxable income is $880,000. Because Elvis's taxable income is above the threshold amount, the QBI component of his Section 199A deduction will be limited to the lesser of (i) 20% of Elvis's share of the LLC's QBI or (ii) the greater of the W-2 wage or W-2 wage and UBIA of qualified property limitations.

Twenty percent of Elvis's share of QBI of $900,000 is $180,000. The W-2 wage limitation equals 50% of Elvis's share of the LLC's wages ($300,000) or $150,000. The combined W-2 and UBIA of qualified property limitation equals $75,750, the sum of 25% of Elvis's share of LLC's wages ($300,000) or $75,000 plus 2.5% of Elvis' share of UBIA of qualified property ($30,000) or $750. The greater of the limitation amounts ($150,000 and $75,750) is $150,000. The QBI component of Elvis's Section 199A deduction is thus limited to $150,000, the lesser of 20% of QBI ($180,000) and the greater of the limitations amounts ($150,000).

Elvis's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($150,000) or 20% of Elvis's taxable income ($880,000 × 20% = $176,000). Therefore, Elvis's Section 199A deduction is $150,000 for the year.

Scenario 2: Barbara and Charlie are married and file a joint individual income tax return. Barbara is a shareholder in M, an entity taxed as an S corporation (non-SSTB) for federal income tax purposes that conducts a single trade or business. M holds no qualified property.

Barbara's share of M's QBI is $300,000 in 2021. Her share of the W-2 wages from M in 2021 is $40,000.

Charlie earns wage income from employment by an unrelated company. After allowable deductions unrelated to M. Barbara and Charlie's taxable income for 2021 is $389,800. Barbara and Charlie are within the phase-in range because their taxable income exceeds the applicable threshold amount, $329,800, but does not exceed the threshold amount plus $100,000, or $429,800. Consequently, the QBI component of Barbara and Charlie's Section 199A deduction may be limited by the W-2 wage and UBIA of qualified property limitations but the limitations will be phased in.

Because M does not hold qualified property, only the W-2 wage limitation must be calculated. In order to apply the W-2 wage limitation, Barbara and Charlie must first determine 20% of Barbara's share of M's QBI. Twenty percent of Barbara's share of M's QBI of $300,000 is $60,000. Next, Barbara and Charlie must determine 50% of Barbara's share of M's W-2 wages. Fifty percent of Barbara's share of M's W-2 wages of $40,000 is $20,000.

Because 50% of Barbara's share of M's W-2 wages ($20,000) is less than 20% of Barbara's share of M's QBI ($60,000), Barbara and Charlie must determine the QBI component of their Section 199A deduction by reducing 20% of Barbara's share of M's QBI by the reduction amount.

The couple is 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). Barbara and Charlie must determine the excess amount, which is the excess of 20% of Barbara's share of M's QBI, or $60,000, over 50% of Barbara's share of M's W-2 wages, or $20,000. Thus, the excess amount is $40,000.

The reduction amount is equal to 60% of the excess amount, or $24,000. Thus, the QBI component of Barbara and Charlie's Section 199A deduction is equal to $36,000, 20% of Barbara's $300,000 share M's QBI (that is, $60,000), reduced by $24,000.

Barbara and Charlie's Section 199A deduction is equal to the lesser of (i) 20% of the QBI from the business as limited ($36,000) or (ii) 20% of the couple's taxable income ($389,800 × 20% = $77,960). Therefore, Barbara and Charlie's Section 199A deduction is $36,000 for 2020.

For owners of SSTB interests, a phase-in rule [as provided in Reg. §1.199A-1(d)(2)] applies to individuals with taxable income within the phase-in range, allowing them to consider the applicable percentage of QBI, W-2 wages, and UBIA of qualified property from an SSTB.

Scenario 2 Variation: Assume the same facts, except that M is engaged in an SSTB.

Because Barbara and Charlie are within the phase-in range, Barbara must reduce the QBI and W-2 wages allocable to Barbara from M to the applicable percentage of those items. Barbara and Charlie's applicable percentage is 100% reduced by the percentage equal to the ratio that their taxable income for the taxable year ($389,800) exceeds their threshold amount ($329,800), or $60,000, bears to $100,000. Their applicable percentage is 40%.

The applicable percentage of Barbara's QBI is $120,000 ($300,000 × 40%), and the applicable percentage of Barbara's share of W-2 wages is $16,000 ($40,000 × 40%). These reduced numbers must then be used to determine how Barbara's Section 199A deduction is limited.

Barbara and Charlie must apply the W-2 wage limitation by first determining 20% of Barbara's share of M's QBI as limited above. Twenty percent of Barbara's share of M's QBI of $120,000 is $24,000. Next, the couple must determine 50% of Barbara's share of M's W-2 wages. Fifty percent of Barbara's share of M's W-2 wages of $16,000 is $8,000. Because 50% of Barbara's share of M's W-2 wages ($8,000) is less than 20% of Barbara's share of M's QBI ($24,000), the couple must determine the QBI component of their

Section 199A deduction by reducing 20% of Barbara's share of M's QBI by the reduction amount.

The couple is 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). Barbara and Charlie must determine the excess amount, which is the excess of 20% of Barbara's share of M's QBI, or $24,000, over 50% of Barbara's share of M's W-2 wages, or $8,000. Thus, the excess amount is $16,000.

The reduction amount is equal to 60% of the excess amount or $9,600. Thus, the QBI component of Barbara and Charlie's Section 199A deduction is equal to $14,400, 20% of Barbara's share M's QBI of $24,000, reduced by $9,600.

The couple's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($14,400) or 20% of Barbara's and Charlie's taxable income ($389,800 × 20% = $77,960). Therefore, the couple's Section 199A deduction is $14,400 for 2020.

AGGREGATION

An individual or RPE may be engaged in more than one trade or business. Generally, each trade or business is a separate trade or business for purposes of applying the limitations described above.

Reg. §199A-4 sets forth rules to allow individuals and RPEs to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described above. Aggregation by taxpayers is not required.

Generally, trades or businesses may be aggregated only if an individual or RPE can demonstrate that—

1. The same person or group of persons, directly or by attribution under IRC Sec(s). 267(b) or 707(b), owns 50% or more of each trade or business to be aggregated. In the case of trades or businesses owned by an S corporation, this means 50% or more of the issued and outstanding shares of the corporation. In the case of trades or businesses owned by a partnership, this means 50% or more of the capital or profits in the partnership,

2. The ownership (as described above) exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income,

3. All items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not considering short taxable years,

4. None of the trades or businesses to be aggregated is an SSTB as defined in Reg. §1.199A-5; and

5. The trades or businesses to be aggregated satisfy at least two of the following factors (based on all the facts and circumstances):

    a. The trades or businesses provide products, property, or services that are the same or customarily offered together.

    b. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

    c. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

EXAMPLE: Determining if separate business activities can be aggregated

Scenario 1: Andy wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all the bookkeeping, tracks, and issues statements on all the receivables, and prepares the payroll for each business. Andy maintains a website and print advertising materials that reference both the catering business and the restaurant. Andy uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

Because the restaurant and catering business are held in disregarded entities, Andy will be treated as operating each of these businesses directly. Both businesses offer prepared food to customers and the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting. Andy may treat the catering business and the restaurant as a single trade or business.

Scenario 1 Variation: Assume the same facts, but the catering and restaurant businesses are owned in separate partnerships and Andy, Ben, Carlos, and Deanna each own a 25% interest in each of the two partnerships. Andy, Ben, Carlos, and Deanna are unrelated.

Because Andy, Ben, Carlos, and Deanna together own more than 50% of each of the two partnerships, they may each treat the catering business and the restaurant as a single trade or business.

Scenario 2: Wayne owns a 75% interest in S1, an S corporation, and a 75% interest in PRS, a partnership. S1 manufactures clothing and PRS is a retail pet food store. Wayne manages S1 and PRS.

Wayne owns more than 50% of the stock of S1 and more than 50% of PRS. Although Wayne manages both S1 and PRS, Wayne is not able to satisfy the aggregation election requirements as the two businesses do not provide goods or services that are the same or customarily offered together; there are no significant centralized business elements; and no facts indicate that the businesses are operated in coordination with, or reliance upon, one another.

Wayne must treat S1 and PRS as separate trades or businesses.

For purposes of Reg. §1.199A-4 and IRC Sec. 267(b), the persons referred to include:

1. Members of a family. The family of an individual shall include his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants,
2. An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual,
3. Two corporations which are members of the same controlled group,
4. A grantor and a fiduciary of any trust,
5. A fiduciary of a trust and—
    a. a fiduciary of another trust, if the same person is a grantor of both trusts,
    b. a beneficiary of such trust,
    c. a beneficiary of another trust, if the same person is a grantor of both trusts,
    d. a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust,
6. A person and an organization to which IRC Sec. 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual,

7. A corporation and a partnership if the same persons own—

    a. more than 50% in value of the outstanding stock of the corporation, and

    b. more than 50% of the capital interest, or the profits interest, in the partnership,

8. An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation,

9. An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation, except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

CAUTION: Certain constructive ownership of stock rules may also apply.

For purposes of determining ownership of stock, stock owned directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family. Also, an individual owning any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner.

For purposes of Reg. §1.199A-4 and IRC Sec. 707(b), the persons referred to include:

1. A partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership, or

2. Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests.

An individual may aggregate trades or businesses operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE. If an individual aggregates multiple trades or businesses, QBI, W-2 wages, and UBIA of qualified property must be combined for the aggregated trades or businesses for purposes of applying the W-2 wage and UBIA of qualified property limitations.

An individual may not subtract from the trades or businesses aggregated by an RPE but may aggregate additional trades or businesses with the RPE's aggregation (if otherwise qualified).

PLANNING TIP: Under Rev. Proc. 2019-38, the rental real estate enterprise (as defined by the taxpayer) will be treated as a single trade or business for purposes of applying the regulations under IRC Sec. 199A, including the application of the aggregation rules in Reg. §1.199A-4.

Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years.

A failure to aggregate will not be considered an aggregation for purposes of this rule. An individual who fails to aggregate *may not* aggregate trades or businesses on an amended return. However, an individual may add a newly created or newly acquired trade or business to an existing aggregated trade or business (including the aggregated trade or business of an RPE), if otherwise qualified under Reg. §199A-4.

In a subsequent year, if there is a significant change in facts and circumstances such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation, then the trades or businesses shall no longer be aggregated.

An individual also must report aggregated trades or businesses of an RPE in which the individual holds a direct or indirect interest.

For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated. The statement must contain—

1. A description of each trade or business,
2. The name and EIN of each entity in which a trade or business is operated,
3. Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year,
4. Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest, and
5. Such other information as the Commissioner may require in forms, instructions, or other published guidance.

PLANNING TIP: An aggregation election may be used to maximize a taxpayer's QBI, wages and UBIA of qualified property when two or more trade or business activities are owned. However, an aggregation election may not be favorable when one (or more) trade or business will rely on wages to maximize the Section 199A deduction, while another trade or business may rely on UBIA to maximize the deduction.

EXAMPLE: Determining Section 199A deduction from multiple sources of trade or business income

Frank is single and owns, as a sole proprietor, 100% of three trades or businesses, Business X, Business Y, and Business Z. None are SSTBs. None of the businesses hold qualified property.

Frank does not aggregate the businesses under Reg. §1.199A-4.

For taxable year 2021, Business X generates $1 million of QBI and pays $500,000 of W-2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages with respect to the business.

After allowable deductions unrelated to the businesses, Frank's taxable income is $2.722 million.

Frank applies the wage and UBIA limitation by determining the lesser of 20% of QBI and 50% of W-2 wages for each business.

For Business X, the lesser of 20% of QBI ($1,000,000 × 20% = $200,000) and 50% of Business X's W-2 wages ($500,000 × 50% = $250,000) is $200,000.

Business Y pays no W-2 wages. The lesser of 20% of Business Y's QBI ($1,000,000 × 20% = $200,000) and 50% of its W-2 wages (zero) is zero.

For Business Z, the lesser of 20% of QBI ($2,000 × 20% = $400) and 50% of W-2 wages ($500,000 × 50% = $250,000) is $400.

Next, Frank must then combine the amounts and compare that sum to 20% of Frank's taxable income. The lesser of these two amounts equals Frank's Section 199A deduction. The total of the combined calculated amounts is $200,400 ($200,000 plus $0 plus $400). Twenty percent of Frank's taxable income is $544,400 ($2,722,000 × 20%).

Frank's Section 199A deduction for 2020 is $200,400.

Variation: Assume the same facts, except that Frank aggregates Business X, Business Y, and Business Z under the rules of Reg. §1.199A-4.

Because Frank's taxable income is above the threshold amount, the QBI component of his Section 199A deduction is subject to the W-2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis.

Frank applies the wage and UBIA limitation by determining the lesser of 20% of the QBI from the aggregated businesses, which is $400,400 ($2,002,000 × 20%) and 50% of W-2 wages from the aggregated businesses, or $500,000 ($1,000,000 × 50%).

Frank's Section 199A deduction is equal to the lesser of $400,400 and 20% of his taxable income ($2,722,000 × 20% = $544,400).

Frank's Section 199A deduction for 2020 is $400,400.

EXAMPLE: Determining Section 199A deduction without aggregating separate trade or business income

Ann's taxable income is $550,000.

She owns interests in two domestic S corporations. Neither are SSTBs.

The Schedule K-1 for First Corporation reports $100,000 QBI, $5,000 W-2 wages and $300,000 UBIA. The Schedule K-1 for Second Corporation reports $100,000 QBI, $40,000 W-2 wages and $5,000 UBIA.

- First Corporation: Lesser of 20% of $100,000 QBI, $20,000 or the wage and basis limitation. The wage and basis limitation is $8,750. This is the greater of 50% of wages ($2,500) or 25% of W-2 wages ($1,250) and 2.5% of UBIA ($7,500) totaling $8,750.

- Second Corporation. Lesser of 20% of $100,000 QBI ($20,000) or the wage and basis limitation. The wage and basis limitation is $20,000. This is the greater of 50% of W-2 wages, $20,000, or 25% of W-2 wages ($10,000) and 2.5% of $5,000 UBIA ($125) or $10,125.

Without an aggregation election, Ann's Section 199A deduction is $28,750.

Variation: Assume the same facts, except that Ann aggregates First Corporation and Second Corporation.

Her Section 199A deduction is the lesser of 20% of aggregated $200,000 QBI ($40,000) or the wage and basis limitation. The wage and basis limitation is $22,500. This is the greater of 50% of aggregated wages ($45,000 total) or $22,500, or 25% of aggregated

W-2 wages and 2.5% of aggregated UBIA ($305,000), or $18,875.

With an aggregation election, Ann's Section 199A deduction is $22,500.

REAL ESTATE INVESTMENT TRUST (REIT) DIVIDENDS AND QUALIFIED PUBLICLY TRADED PARTNERSHIP (PTP) INCOME

The Section 199A deduction may garner taxpayer's a deduction of up to 20% of their QBI from a trade or business, including income from a pass-through entity, plus 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

Qualified REIT dividends and qualified PTP income are the sum of qualified REIT dividends earned directly or through an RPE and the net amount of qualified PTP income earned directly or through an RPE.

If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in succeeding taxable years for purposes of IRC Sec. 199A. This carryover rule does not affect the deductibility of a loss for purposes of other provisions of the Code.

The term *qualified REIT dividend* means any dividend from a REIT which is not—

1. A capital gain dividend, as defined in IRC Sec. 857(b)(3), nor
2. Qualified dividend income, as defined in IRC Sec. 1(h)(11).

The term *qualified REIT dividend* does not include any REIT dividend received with respect to any share of REIT stock—

1. That is held by a shareholder for 45 days or less during the 91-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend, or
2. To the extent that a shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

The term qualified *PTP income* means the sum of—

1. The net amount of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP as defined in IRC Sec. 7704(b) that is not taxed as a corporation, plus

2. Any gain or loss attributable to assets of the PTP giving rise to ordinary income under IRC Sec. 751(a) or (b) (the hot asset rules) considered attributable to trades or businesses conducted by the partnership.

The rules applicable to the determination of QBI for a taxpayer's trade or business also apply to the determination of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP.

An individual's allocable share of income from a PTP, and any Section 751 gain or loss is qualified PTP income only to the extent the items are included or allowed in determining taxable income for the taxable year, and the requirement that the item be effectively connected with the conduct of a trade or business within the United States. For example, if an individual owns an interest in a PTP, and for the taxable year is allocated a distributive share of net loss which is disallowed under the passive activity rules of IRC Sec. 469, the loss is not considered for purposes of IRC Sec. 199A.

The SSTB limitations also apply to income earned from a PTP. Furthermore, each PTP is required to determine its qualified PTP income for each trade or business and report that information to its owners.

EXAMPLE: Effects of REIT income and PTP income on Section 199A deduction

Scenario 1: Bonnie and Clyde are married and file a joint individual income tax return. Bonnie earns $50,000 in wages as an employee of an unrelated company during the year. Clyde owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations. X pays Clyde $150,000 in wages during the year.

Bonnie also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income for the year. Bonnie and Clyde have no capital gains or losses.

After allowable deductions not related to X, Bonnie and Clyde's total taxable income for the year is $271,500 and their total Section 199A deduction is equal to $20,300. This is the lesser of 20% of Clyde's QBI from the business ($100,000 × 20% = $20,000) plus 20% of Bonnie's combined qualified REIT dividends and qualified PTP income ($1,500 × 20% = $300), or 20% of Bonnie and Clyde's total taxable for the taxable year ($271,500 × 20% = $54,300).

Scenario 2: Omar, an unmarried individual, owns a 50% interest in Z, an S corporation for Federal income tax purposes that conducts a single trade or business. During the year, Z reports QBI of $6,000,000. Z pays total W-2 wages of $2,000,000, and its total UBIA of qualified property is $200,000.

For the taxable year, Omar reports $3,000,000 of QBI from Z. Omar is not an employee of Z and receives no wages or reasonable compensation from Z.

After allowable deductions unrelated to Z and a deductible qualified net loss from a PTP of ($10,000), Omar's taxable income is $1,880,000. Because Omar's taxable income is above the threshold amount, the QBI component of Omar's Section 199A deduction will be limited to the lesser of 20% of Omar's share of Z's QBI or the greater of the W-2 wage and UBIA of qualified property limitations.

Twenty percent of Omar's share of Z's QBI ($3,000,000) is $600,000. The W-2 wage limitation equals 50% of Omar's share of Z's W-2 wages ($1 million) or $500,000. The UBIA of qualified property limitation equals $252,500, the sum of 25% of Omar's share of Z's W-2 wages ($1 million) or $250,000 plus 2.5% of Omar's share of UBIA of qualified property ($100,000) or $2,500. The greater of the limitation amounts ($500,000 and $252,500) is $500,000. The QBI component of Omar's Section 199A deduction is thus limited to $500,000, the lesser of 20% of QBI ($600,000) and the greater of the limitations amounts ($500,000).

Omar reports a qualified loss from a PTP and has no qualified REIT dividends. Omar does not net the ($10,000) loss from the PTP against QBI. Instead, the portion of Omar's

Section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the year.

Omar's Section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($500,000) or 20% of Omar's taxable income over net capital gain ($1,880,000 × 20% = $376,000). Therefore, Omar's Section 199A deduction is $376,000 for the year.

Omar must also carry forward the ($10,000) qualified loss from a PTP to be netted against his qualified REIT dividends and qualified PTP income in the succeeding taxable year.

WHERE TO GO FOR MORE INFORMATION

- IRS Publication 535, *Business Expenses*
- Section 199A—Qualified Business Income Deduction FAQs at **www.irs.gov**
- Instructions for Forms 8995 (Qualified Business Income Deduction Simplified Computation) and 8995-A (Qualified Business Income Deduction)

CHAPTER 41 : ADJUSTMENTS TO INCOME

Learning Objectives

Completion of this chapter will enable participants to—

- Recognize the rules regarding the deductibility of educator expenses.
- Identify the rules regarding the deductibility of certain expenses of reservists, performing artists, and fee-based government officials.
- Assess the rules regarding health savings accounts (HSAs).
- Apply the rules regarding the deductibility of moving expenses.
- Calculate the deduction for self-employed health insurance.

1. The moving (and medical) mileage rate for 2021 is $ .16 per mile, down from $ .17 in 2020 [IRS Notice 2021-02].

EDUCATOR EXPENSES

The PATH Act made permanent the deductibility of eligible educator expenses of up to $250 [IRC Sec. 62(a)(2)(D)] and made the $250 limitation indexed for inflation, though it remains $250 for 2020 [Rev. Proc. 2019-44]. Amounts more than $250 are no longer deductible as a miscellaneous itemized deduction subject to the 2% floor, because the deductibility of miscellaneous itemized deductions subject to the 2% floor was temporarily repealed by the TCJA for tax years 2018 through 2025.

Taxpayers filing joint returns who are both eligible educators are each eligible for the $250 deduction, for a total of $500 on the return, but neither spouse can deduct more than $250 of his own expenses.

Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (including computer equipment, software, and services), other materials used in the classroom, and professional development [IRC Sec. 62(a)(2)(D)]. Qualified expenses *do not* include expenses for homeschooling or for nonathletic supplies for courses in health or physical education.

An *eligible educator* is a kindergarten-through-grade-12 teacher, instructor, counselor, principal, or aide in a public or private school for at least 900 hours during a school year [IRC Sec. 62(d)(1)(A)].

CERTAIN BUSINESS EXPENSES OF RESERVISTS, PERFORMING ARTISTS, AND FEE-BASIS GOVERNMENT OFFICIALS

This information is reported on Form 2106 and flows to Form 1040, Schedule 1.

Include the following deductions:

1. Certain business expenses of National Guard and reserve members who travel more than 100 miles from home to perform services as a National Guard or reserve member.

2. Performing-arts-related expenses as a qualified performing artist. A qualifying performing artist:

   a. Performed services in the performing arts as an employee for at least two employers during the tax year,

   b. Received wages of $200 or more per employer from at least two of those employers,

   c. Had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts, and

   d. Had adjusted gross income of $16,000 or less before deducting expenses as a performing artist.

3. Business expenses of fee-basis state or local government officials.

HEALTH SAVINGS ACCOUNT (HSA) DEDUCTION

A *health savings account* (HSA) is a tax-exempt trust or custodial account established to pay unreimbursed qualified medical expenses of a participant. To be eligible for a health savings account (HSA), a beneficiary must have a high deductible health plan (HDHP). Eligibility for an HSA is determined monthly.

In general, eligible individuals do not have access to full coverage health plans. This would include self-employed or unemployed taxpayers, small business owners and small-firm employees. An eligible individual must be [IRC Sec. 223(c)(1)]:

1. Covered by an HDHP as of the 1st of the month,

2. Not eligible for Medicare (currently at age 65),

3. Not claimed as a dependent, and

4. Not covered by other health insurance, excluding permitted insurance and permitted coverage, such as disability, dental, vision, and long-term care insurance.

Contributions to an HSA are pre-tax. If contributions are made by an employer on behalf of an employee, they are not included in income. If made by the employee, contributions are a pre-AGI deduction on the employee's Form 1040 (Schedule 1) and cannot be deducted as a medical expense on Schedule A.

Distributions from an HSA to pay qualified medical expenses are not taxable. Nonqualified distributions are taxable and generally subject to a 20% penalty.

High-Deductible Health Plan (HDHP)

An HDHP must require a minimum deductible amount and a maximum annual out-of-pocket amount per IRC Sec. 223(c)(2)(A). However, under a safe harbor, an HDHP may provide preventative care benefits without a deductible or with a deductible below the minimum annual deductible otherwise required. [IRC Sec. 223(c)(2)(C)].

The CARES Act establishes a safe harbor allowing high-deductible health plans (HDHPs) to cover telehealth and other remote-care services without a deductible for plan years beginning on or before December 31, 2021. In addition, coverage for telehealth and other remote care will be disregarded when determining whether an individual has impermissible non-HDHP coverage in the case of plan years beginning on or before December 31, 2021. This provision is effective March 27, 2020 (the date of the law's enactment).

Note that this temporary safe harbor applies generally to HDHP coverage for telehealth and other remote-care services and is not limited to coverage for COVID-19-related services. Clarification is also provided that an otherwise eligible individual with coverage under an HDHP may also receive coverage for telehealth and other remote-care services outside the HDHP and before satisfying the deductible of the HDHP and still contribute to an HSA.

IRS Notice 2020-15 allows HDHPs to provide benefits associated with COVID-19 testing and treatment without a deductible, or with a deductible below the applicable HDHP minimum deductible (self-only or family). A health plan that otherwise meets the HDHP requirements will not fail to qualify as an HDHP merely because it provides medical care services and items related to COVID-19 testing and treatment before the applicable HDHP minimum deductible is satisfied. Thus, individuals can remain covered under HDHPs that provide such benefits on a no- or low-deductible basis without any adverse effect on HSA eligibility.

HDHP Deductibles per Rev. Proc(s). 2020-32 and 2021-25

	2021		**2022**	
	Minimum	**Maximum**	**Minimum**	**Maximum**
Self	$1,400	$7,000	$1,400	$7,050
Family	$2,800	$14,000	$2,800	$14,100

Out-of-pocket costs are amounts an individual must pay for qualified medical expenses charged against their deductible, co-payments (even if not applied to a deductible), and other amounts. Applies only to expenses covered by the HDHP (Notice 2008-59, Q&A 15).

NOTE: IRS Notice 2008-59 consists of 42 questions and answers providing guidance on a range of issues including eligible individuals, HDHPs, contributions, distributions, and prohibited transactions.

The term *family coverage* means any coverage other than self-only coverage, covering one eligible individual and at least one other individual (regardless of eligibility) [Notice 2004-50, Q&A 12]. If a family coverage HDHP has individual embedded deductible amounts for each family member, they must be at least the minimum deductible for HDHP family coverage. An HDHP must be in place before an HSA can be established and contributions made.

Establishing an HSA

HSAs are not regulated by each state and providers are national. Any institution qualified to provide an IRA is authorized to provide an HSA, including insurance companies, banks, investment companies, etc. Some insurance companies provide both HDHPs and the HSAs.

The maximum annual contribution to an HSA is the sum of limits determined separately for each month, based on status, eligibility, and health plan coverage as of the first day of the month [IRC Sec. 223(b)(1)].

The maximum annual contributions per Rev. Proc(s). 2020-32 and 2021-25 are—

	2021	2022
Self	$3,600	$3,360
Family	$7,200	$7,300
Age 55 and up	$1,000	$1,000

1. Taxpayers age 55 (not 50, as for retirement plans) or older on or before December 31, are eligible for the additional catch-up contribution amount of $1,000 [IRC Sec. 223(b)(3)(B)].

2. Contributions may be made in one or more payments any time between the first day of the year and the filing deadline (without extension) of the account beneficiary's income tax return (Notice 2004-2, Q&A 21).

3. Anyone may contribute to an HSA on behalf of an eligible individual. However, the aggregate contribution from all sources must not exceed the maximum allowable contribution for the eligible individual (Notice 2004-50, Q&A 28).

4. Excess contributions not removed by the return due date (including extensions) is subject to a 6% excess contributions penalty [IRC Sec. 4973(g)].

Distributions

Qualifying medical expenses are those incurred for benefit of a beneficiary, spouse, or dependent for medical care, as defined in IRC Sec. 213(d).

The CARES Act removes the prescription requirement for *over the counter* (OTC) drug reimbursements that previously applied to HSAs, as well as to health flexible spending accounts (FSAs), health reimbursement arrangements (HRAs), and other accident and health plans. The change generally applies to expenses incurred after December 31, 2019; in the case of HSAs, it applies to amounts paid after that date.

The CARES Act also provides that menstrual care products will qualify as medical care for purposes of tax-free distribution from an HSA or reimbursement from a health FSA, HRA, or other accident and health plan. The change generally applies to expenses incurred after December 31, 2019; in the case of HSAs, it applies to amounts paid after that date.

It is important to note that these changes do not have an expiration date.

Qualified expenses *do not* include payment of health insurance premiums, except for the following:

1. COBRA policy,

2. Qualified long-term care policy,

3. Health plans maintained while receiving unemployment, and

4. For individuals 65 and over, any health insurance premiums other than for a Medicare supplemental policy.

Qualifying distributions are nontaxable. Distributions are reported to an account owner on Form 1099-SA, Distributions From an HSA, Archer MSA, or Medicare Advantage MSA. Form 8889, Health Savings Accounts (HSAs), is used to report distributions from an HSA account and report qualified medical expenditures.

For taxpayers under 65 years-old, non-qualifying distributions are taxable and subject to a 20% additional penalty tax [IRC Sec. 223(f)(4)]. Distributions to taxpayers aged 65-and-older or to those who are disabled or deceased (beneficiary) are not subject to a penalty.

To prove distributions are qualifying, an individual account beneficiary must retain records corroborating:

1. Distributions were to pay or reimburse qualified medical expenses,

2. Those qualified medical expenses had not been previously paid for or reimbursed from another source, and

3. Those qualified medical expenses are not being taken as an itemized deduction on Schedule A.

Procedures for a one-time IRA-to-HSA transfer (Notice 2008-51) are as follows:

1. An eligible taxpayer may make a one-time transfer from either a traditional or Roth IRA to an HSA [IRC Sec. 408(d)(9)].

2. The amount transferred counts against a taxpayer's maximum annual HSA contribution but is not allowed to reduce AGI for that year.

3. The transfer (rollover) must be made directly by an IRA trustee or a taxpayer's employer.

EXAMPLE: Treatment of IRA rollover to HSA

Harry, age 58, has a traditional IRA and family HDHP coverage at the time of a fund transfer from his IRA to his HSA. Harry is allowed a funding distribution of $8,300 (including the $1,000 catch-up provision) in 2022.

HSA PLANNING POINT: Instead of using an HSA for current medical expenses, a taxpayer can accumulate the funds every year and let it grow. After age 65, in retirement, a taxpayer can use the account for allowable medical expenses, when income is down, and expenses may be up. The withdrawals would be tax-free

The amount can also be used as another IRA with the funds being taxed but another way of accumulating funds.

IRS Notice 2013-54 states that group health plans offering group or individual health insurance coverage are generally prohibited from imposing lifetime or annual limits on the dollar value of health benefits. However, a restriction on annual limits (Public Health Service Act Sec. 2711) does not apply to either HSAs (IRC Sec. 223) or medical savings accounts (IRC Sec. 220).

ABOVE-THE-LINE DEDUCTION FOR CHARITABLE CONTRIBUTIONS

Cares Act §2204 permits an eligible individual to claim an above-the-line deduction in an amount not to exceed $300 for qualified charitable contributions made during a taxable year that begins in 2020.

In the spending package that was passed by Congress at the end of 2020, this deduction was enhanced and extended through 2021. For tax year 2021, taxpayers can take a tax deduction up to $300 each for cash (monetary) donations to qualifying charities. This means if you file your tax return jointly with your spouse when you file in 2022 for the 2021 tax year, you will be able to claim up to a $600 deduction.

NOTE: For 2020,according to the Joint Committee on Taxation's explanation of the CARES Act, the $300 limit applies to the tax-filing unit. Married taxpayers who filed a joint return and do not elect to itemize deductions are allowed to deduct up to a total of $300 (not $600) in qualified charitable contributions on the joint return.

An *eligible individual* is an individual who does not elect to itemize deductions. Thus, a taxpayer taking the federal standard deduction, who would otherwise not be able to deduct any charitable contributions, may claim an above-the-line deduction for qualified charitable contributions.

A *qualified charitable contribution* is a cash contribution for which a deduction is allowable under IRC Sec. 170 (determined without regard to the percentage limitations) that is paid to a charitable organization described in IRC Sec. 170(b)(1)(A), other than contributions to (i) a supporting organization described in IRC Sec. 509(a)(3) or (ii) for the establishment of a new, or maintenance of an existing, donor advised fund (DAF).

Contributions of noncash property, such as securities, *are not* qualified contributions.

A qualified charitable contribution *does not* include an amount that is treated as a contribution in the taxable year by reason of being carried forward from a prior contribution year.

MOVING EXPENSES

The TCJA suspended the moving expense deduction for tax years beginning after December 31, 2017, and before January 1, 2026, except for members of the Armed Forces of the United States on active duty that move due to a military order for a permanent station change [IRC Sec. 217(k)].

Form 3903, Moving Expenses, is used to take a deduction for unreimbursed moving expenses paid or incurred during the taxable year in connection with the commencement of work by a member of the Armed Forces of the United States on active duty [IRC Sec. 217(a)].

Limitations under IRC Sec. 217(c) regarding the 50-mile distance test and the 39-week/78-week time tests do not apply to members of the U.S. Armed Forces on active duty who move under military order due to a permanent station change [IRC Sec. 217(g)(1)].

Direct Moving Expenses [IRC Sec. 217(b)(1)]

1. Costs of moving a taxpayer and household members and their household goods, pets, automobiles, and personal effects from a former residence to a new residence. Direct expenses also include the cost of connecting or disconnecting utilities, packing, crating, insurance, and in-transit storage of up to 30 consecutive days.

2. If moving expenses are incurred from a place other than a taxpayer's former residence (e.g., from storage), moving costs may not exceed what would have been allowed if they had been incurred in moving from the taxpayer's former residence.

3. Direct moving expenses also include travel expenses such as transportation and lodging from the former residence to the new residence (but not meals), and automobile expenses. Taxpayers may deduct the greater of actual out-of-pocket costs (excluding depreciation, general repairs or maintenance, and insurance), or $0.17 per mile for moves occurring during 2020. Note that parking fees and tolls may be deducted regardless of which method is used.

Employer Reimbursements of Moving Expenses

The TCJA temporarily suspended the exclusion from gross income of qualified moving expense reimbursements for tax years beginning after December 31, 2017 and before January 1, 2026, except for members of the U.S. Armed Forces on active duty who move due to a permanent station change.

If a member of the Armed Forces on active duty is ordered to move in connection with a permanent change of station, the value of moving and storage services provided in kind, as well as reimbursements or allowances received for moving and storage expenses, are excluded from gross income. This rule also applies with respect to moving trailers or mobile homes.

The above rules apply to moving and storage services, reimbursements and allowances provided for the member of the Armed Services, his spouse, and his dependents, but only to the extent of the expenses actually paid or incurred [IRC Sec. 217(g)(2)].

Special rules for foreign moves. Reasonable storage costs are allowed for the cost of storing personal effects for all or part of the time the service member is outside the U.S.

SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

Self-employed (SE) taxpayers can deduct 100% of the medical, dental, and qualifying long-term care insurance costs paid for themselves, their spouses, their dependents, and children under age 27 at the end of the year even if the children are not dependents [IRC Sec. 162(l)(1)].

NOTE: A non-dependent child would have to live in the same home with the taxpayers for the entire year for the same insurance premiums to be deductible as a medical expense on Schedule A. In other words, a child would have to be a qualifying relative, but for the income limitation, for the parents to have a Schedule A medical deduction.

The following special rules apply to the deduction [IRC Sec. 162(l)(2)]:

1. Employer-subsidized health plan. The deduction applies only for calendar months when a self-employed taxpayer is not eligible to participate in a subsidized health plan maintained by any employer of the taxpayer, the taxpayer's spouse, any dependent of the taxpayer, or under-age-27 child of the taxpayer.

2. Earned income limit. The deduction applies only if a medical insurance plan is established by a taxpayer's business and only to the extent of the taxpayer's earned income from such business [IRC Sec. 162(l)(2)(A)].

The underlying business must be one in which the personal services of the self-employed person are a material income-producing factor [IRC Secs. 162(l)(1) and 401(c)(2)(A)(i)].

Partners may claim a deduction for premiums paid on a medical insurance policy in either the partner's name or the name of the partnership or LLC taxed as a partnership:

1. If the partnership directly pays the premiums, and they are reported on the partner's Schedule K-1 (Form 1065) as guaranteed payments (and in box 13, Code M, amounts paid for medical insurance) includable in the partner's income (Rev. Rul. 91-26).

2. If the partner pays the premiums, furnishes proof to the partnership, and then the partnership reimburses the partner and reports the premiums on the partner's Schedule K-1 (Form 1065) as guaranteed payments includable in the partner's income (IRS Pub. 535).

3. If the premium payments are for a partner who did not render services in their capacity as a partner or when the payments depend on partnership income, they are treated as distributions to the affected partners and only potentially deductible as an itemized deduction.

The IRS has concluded that for a more-than-2% S corporation shareholder to claim a deduction under IRC Sec. 162(l), the corporation must establish (or be deemed to establish) a medical plan that covers the shareholder-employee (IRS Notice 2008-1). The requisite plan is deemed to exist in both of the following circumstances:

1. The S corporation directly pays the premiums, and the company-paid premium amounts are reported as compensation on the more-than-2% shareholder-employee’s Form W-2. The corporation can claim a wage deduction for the premiums on Form 1120-S.

2. The more-than-2% shareholder pays the premiums, furnishes proof, and the S corporation reimburses the shareholder in the current year. The premium amounts must be included as compensation on the more-than-2% shareholder-employee’s Form W-2. The corporation can claim a wage deduction for the premiums on Form 1120-S.

Certain family members of a greater than 2% shareholder are also treated as greater than 2% shareholders under IRC Sec. 318’s stock ownership attribution rules [IRC Sec. 1372(b)] and are allowed the deduction if they meet the other requirements of IRC 162(l) [CCA 201912001].

A self-employed person’s (or a more-than-2% S corporation shareholder-employee’s) health insurance premiums are only eligible for the above-the-line deduction to the extent they are less than or equal to the individual’s earned income from the business that established the health insurance plan:

1. For an S shareholder, earned income equals the shareholder-employee’s taxable cash wages, before adding the insurance premiums, from the corporation (as shown on Form W-2) [IRC Sec. 162(l)(5)(A)].

2. For other taxpayers, earned income equals net SE earnings less the deduction for the employer equivalent portion of SE tax and the deduction for a Keogh, SEP, or SIMPLE IRA contribution.

EXAMPLE: SE tax treatment of medical insurance premiums

Paul is president and sole shareholder of Family, Inc., an S corporation. Paul's Form W-2 from Family, Inc. shows wages of $60,000 and taxable wages of $68,000, which include $8,000 of medical insurance premiums paid by the company for him and his family. His Schedule K-1 from Family, Inc. reflects a $75,000 net loss passed through for the current year. Neither Paul nor his spouse is eligible to participate in an employer-subsidized health plan.

They may claim the $8,000 of premiums on their Form 1040 (Schedule 1). The $75,000 pass-through loss has no effect on the deductibility of the health insurance premiums; Paul's wages of $60,000 are his earned income from Family, Inc.

NOTE: CCA 201228037 states all Medicare parts (A, B, C, and D) may be deducted as SE health insurance under IRC Sec. 162(l). The Chief Counsel Advice further concluded that the deduction is only valid where the requirements of IRS Notice 2008-1 are met. Therefore, a partner in a partnership or a more-than-2% shareholder in an S corporation would have to be reimbursed by the respective entity for any premiums paid personally. A partnership would report the payments as guaranteed payments and an S corporation would add the reimbursement to wages on Form W-2. Self-employed individuals who failed to deduct Medicare premiums in previous years may file amended returns, subject to the statute of limitations.

CAUTION: Many changes have been made to the way health insurance and related benefits are handled by the Patient Protection and Affordable Care Act (ACA). Gear Up's Business Entities manual has a detailed discussion on treatment of S corporation healthcare arrangements for greater than 2% shareholders, including IRS Notices 2008-1, 2013-54 and 2015-17.

Effect of the Premium Tax Credit

The calculation of the SE health insurance deduction for a taxpayer receiving a premium tax credit is a circular calculation:

1. The credit is dependent on MAGI.
2. MAGI begins with AGI.
3. A self-employed health insurance deduction is an adjustment to AGI.
4. A taxpayer may only deduct as SE health insurance the portion of premiums for which he is out-of-pocket.
5. Therefore, a deduction must be adjusted for additional (or repaid) premium tax credit.

A taxpayer may determine amounts for the SE health insurance deduction and the premium tax credit using any method, provided the requirements of applicable tax law are satisfied. Rev. Proc. 2014-41 describes two calculations a taxpayer may use;the iterative and the alternative methods.

A taxpayer must use the worksheets in IRS Pub. 974 [Premium Tax Credit (PTC)] instead of the worksheets in the Form 1040 instructions to calculate an SE health insurance deduction if the insurance plan established, or considered to be established, under the business, was obtained through the Exchange (Marketplace) and the taxpayer is claiming a premium tax credit.

> **NOTE:** IRS Pub. 974 refers to the iterative calculation method as the iterative calculation method but refers to the alternative calculation method as the simplified calculation method.

These calculations affect only *specified premiums*, which are premiums for a specified qualified health plan or plans for which a taxpayer may otherwise claim a deduction for self-employed health insurance.

A *specified qualified health plan* (QHP) is any QHP that covers the taxpayer, the taxpayer's spouse, and/or a dependent of the taxpayer (enrolled family member) for a month that as of the first day, the individual is enrolled in a QHP through an Exchange [Reg. §1.36B-3(c)(1)(i)].

The iterative calculation is at least a six-step, time-consuming calculation for which no examples are provided in Rev. Proc. 2014-4. The authors believe this is a complete waste of time because the difference in results using the easier alternative calculation is negligible.

The alternative (simplified) calculation is a 4-step calculation provided in Rev. Proc. 2014-41:

- **Step 1:** Determine AGI, MAGI, and household income by taking a SE health insurance deduction [IRC Sec. 162(l)] for specified premiums after applying the limit for the premium repayment. (See amounts in the table above.)
- **Step 2:** Compute the initial premium tax credit using the AGI, MAGI, and household income determined in Step 1.
- **Step 3:** Determine the IRC Sec. 162(l) deduction by subtracting the Step 2 premium tax credit amount from the specified premiums and then applying the limit for repayment of the credit.
- **Step 4:** Compute the final premium tax credit using the AGI, MAGI, and household income determined by considering the IRC Sec. 162(l) deduction in Step 3.

The taxpayer may claim the amount of the premium tax credit determined under Step 4 and the amount of Section 162(l) self-employed health insurance deduction for the specified premiums determined under Step 3.

A taxpayer's SE health insurance deduction may not exceed the lesser of—

1. The taxpayer's earned income [within the meaning of IRC Sec. 401(c)] derived by the taxpayer from the trade or business with respect to which the health insurance is established, and
2. The sum of the specified premiums not paid through advance credit payments and the limitation on additional tax determined under Reg. §1.36B-4(a)(3)(iii).

PENALTY ON EARLY WITHDRAWAL OF SAVINGS

A deduction for amounts charged by a bank or similar institution as a penalty for early withdrawal of funds from a certificate of deposit or a time savings account. Forms 1099-INT or 1099-OID must report both the entire amount of accrued interest and the penalty paid as they are two separate transactions, and not netted (Rev. Rul. 75-20):

1. The full amount of the accrued interest received is reported on Form 1040 as taxable interest.

2. The full amount of the penalty paid is reported on Form 1040, Schedule 1, as a deduction from total income in computing AGI.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*

- IRS Pub. 974, *Premium Tax Credit (PTC)*

- Notice 2008-59, Health Savings Accounts

- Notice 2015-17, Guidance on the Application of Code Sec. 4980D to Certain Types of Health Coverage Reimbursement Arrangement

CHAPTER 42: DECEDENT'S FINAL RETURN

EARNING OBJECTIVES

Completion of this chapter will enable participants to—

- Identify the actions needed for correctly filing a decedent's final return.
- Evaluate tax issues specific to a decedent's final return.

DECEDENT FILING REQUIREMENTS

Form 1040 is generally required if the gross income of a decedent equals or exceeds the sum of the basic standard deduction, including the additional standard deduction for age 65-or-older taxpayers. The standard deductions are not prorated for a short year but are allowed in full for the decedent.

Generally, married individuals must file a return if a decedent's gross income combined with their spouse's gross income, for the tax year is more than the standard deduction that applies for a joint return, if—

1. The decedent and spouse, at the close of the tax year (or at date of death), had the same household as their home; and
2. The spouse does not file separately.

Generally, a representative must file an income tax return for a decedent if both of the following are true:

1. The representative is the surviving spouse, executor, administrator, or legal representative.
2. The decedent met the above filing requirements at the time of death.

A return is also required if the decedent —

1. Owed any special taxes (e.g., AMT, additional tax on a qualified plan distribution).
2. Received Archer or Medicare Advantage MSA or health savings account distributions.
3. Had net earnings from self-employment of at least $400.
4. Had advanced payment of the premium tax credit or health coverage credit was made for the decedent, their spouse, or dependent.
5. Had received $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.
6. Is due a refund if tax was withheld from salaries, wages, pensions, or annuities, or if estimated tax was paid, even if a return isn't otherwise required to be filed. Also, the decedent may be entitled to other credits that result in a refund.

> **NOTE:** A decedent's final return is for the year when the taxpayer died. Thus, if a decedent died on March 1, 2022, before filing the 2021 return, the personal representative will file a normal year return for 2021, and 2022 will be the decedent's final return [IRS Pub. 559].

DECEDENT'S FILING STATUS

Married Filing Joint (MFJ)

Both the estate's executor or administrator and the surviving spouse must consent to filing a joint return. The fiduciary is under a duty, unless the will of the decedent directs otherwise, to consider whether it is for the overall benefit of the estate to consent to an MFJ return. The usual advantages and disadvantages of joint filing should be considered.

If an executor or administrator has not been appointed, the surviving spouse can decide whether to file a joint or separate return. However, an MFJ return with a deceased spouse *cannot* be filed if the surviving spouse remarries before the end of the year of the decedent's death. The decedent must instead file MFS [IRS Pub. 559].

If an executor or administrator is appointed later, they may disaffirm a joint return election by filing a separate return [Reg. §1.6013-1(d)(5)]. The disaffirmance must be made within one year from the due date of the return, including extensions. The joint return made by the surviving spouse will then be regarded as the separate return of that spouse by excluding the decedent's items and refiguring the tax liability.

In some cases, one spouse may be relieved of joint liability for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. If a decedent qualifies for this relief while alive, the personal representative can pursue an existing request, or file a request, for relief from joint liability. For information on requesting this relief, see Pub. 971, Innocent Spouse Relief.

> **NOTE:** Changing from an MFJ to an MFS return is an exception to the general rule that the election to file an MFJ return is irrevocable.

An executor or administrator may also elect to file a MFJ return with the decedent's spouse:

1. Even if a MFS return has already been filed for the decedent.

2. The election must be made within three years of the due date, without extension, for filing the decedent's return [IRC Sec. 6013(b)(2)(A)].

If both spouses die within the same year, a joint return may be filed for both decedents.

A special rule applies to a spouse of a person in the armed forces and government employees who are in missing status (e.g., missing in action, prisoner of war) because of service in a combat zone. The spouse, if otherwise entitled to file a joint return, may elect to file a joint return for any year which begins on or before the day which is two years after the date of termination of combatant activities in that zone. The election is made by filing a joint return. IRS has issued no regulations as to any statement that should be submitted with the return.

Married Filing Separately (MFS)

If uncertain as to whether to file a MFJ or MFS return, file a MFS return because the election to file a MFJ return extends up to three years from the due date of the original return [IRC Sec. 6013(b)(2)(A)].

Potential disadvantages:

1. If separate returns are filed and itemized deductions are elected by (or for) one spouse, the other spouse must also itemize deductions.
2. Loss of certain credits.
3. Increase in taxable social security benefits.
4. Loss of up to $25,000 in allowed losses of active real estate rentals.

ADDITIONAL INFORMATION

The due date of the return is the same as if death had not occurred (generally April 15).

Where there is no surviving spouse and no executor or administrator has been appointed (e.g., all assets were held in joint tenancy with a non-spouse):

1. The personal representative (typically the person in charge of the decedent's property) files on behalf of the decedent.
2. The personal representative's name would appear after the decedent's name on page one of the return, and the representative's address is used.

Signature if married:

1. Married filing jointly (surviving spouse must sign).
    a. If no executor or administrator, the surviving spouse should sign the return and write in the signature area "filing as surviving spouse" [IRS Pub. 559].
    b. If an executor or administrator has been appointed, he or she also signs the return on behalf of the decedent, along with the surviving spouse.
2. Married filing separate.
    a. If an executor or administrator has been appointed, he or she must sign the return.
    b. If no executor or administrator has been appointed and if there is no surviving spouse, the personal representative must sign the return as "personal representative."

Indicate "deceased" across the top of the decedent's return, the taxpayer's name, and date of death (DOD) (or check a box in your software and enter the DOD).

Use Form 1310 to claim a refund on behalf of a deceased taxpayer. However, no Form 1310 is required if either of the following applies:

1. Filer is the surviving spouse filing an original or amended joint return with the decedent, or

2. Filer is a personal representative filing an original Form 1040, Form 1040-SR, Form 1040-NR, or Form 1040-NR-EZ for the decedent and a court certificate showing his or her appointment is attached to the return.

NOTE: The IRS only issues refund checks in the name of the surviving spouse. If the check is in both spouses' names, it should be returned to the IRS with a note and they will re-issue a properly addressed check.

INCOME (DEDUCTIONS) TO BE INCLUDED IN THE FINAL RETURN

The final Form 1040 should include all income and deductions up to and including the DOD, based upon the method of accounting used by the decedent while alive. Income included for the rest of the year is reported on the estate's initial Form 1041 income tax return.

Cash Method

Include items of income actually or constructively received before death. Uncashed checks received prior to a decedent's death are constructively received.

Interest is constructively received when subject to withdrawal. Interest from coupons on bonds that matured prior to the death of the taxpayer but are uncashed is constructively received [Reg. §1.451-2(a) and (b)].

Include expense items actually or constructively paid before death.

Accrual Method

Income and deductions accrued before death are included on the final 1040.

Income or deductions accruing only by reason of a decedent's death are not included in the decedent's final return [IRC Sec. 451; Reg. §1.451-1(b)(1)].

CAUTION: A deceased taxpayer's Form 1040 cannot report any income received after death. Beware of incorrect Form(s) 1099 received; they will likely need to be allocated between Forms 1040 and 1041.

NEW DEVELOPMENT: The CARES Act provides for special tax treatment for a coronavirus-related distribution (up to $100,000). Among other benefits, the new law allows the distribution to be included in income ratably over three years (⅓ in 2020, ⅓ in 2021 and ⅓ in 2022).

However, Notice 2020-50 clarifies that if a qualified individual dies before the full taxable amount of the COVID-19-related distribution has been included in his or her gross income, then the remainder must be included in gross income for the taxable year that includes the individual's death.

Series EE and Series I Bonds Reporting

If a decedent has not elected to report the interest annually, under IRC Sec. 454(a) the personal representative may:

1. Elect to report all such accrued interest on the savings bonds (up to DOD) on the decedent's final 1040 [Rev. Rul. 68-145] or

2. Include none of the accrued interest in the decedent's final 1040. In this case, income will be reported by the successor in interest, and will include all income accrued from the date the decedent acquired the bonds through the date the successor in interest disposes of the bonds.

If a decedent has elected to report the interest annually, the increase in the value of the bonds (in the year of death) up to the DOD must be reported on the decedent's final 1040.

> **PLANNING TIP:** In certain circumstances, it may be advisable to report all accrued interest on savings bonds as of DOD on a decedent's final return. This might be true if death occurs early in the calendar year, the decedent is in a lower tax bracket than the beneficiary or has large medical deductions.

Installment Sales

Death is not a disposition under IRC Sec. 453B(c). If a sale is completed prior to death, but the sales proceeds are collected after death, it is an installment sale (PLR 8545052). A personal representative can elect out of installment sale treatment if the sale occurred in the year of death.

Sale of a Personal Residence

Decedents may exclude up to $250,000 ($500,000 if married at the time of a sale) of gain from a sale of a principal residence sold prior to death. If one spouse dies and the home is sold in the year of the deceased spouse's death, the surviving spouse can file as MFJ, with the $500,000 MFJ exclusion available as long as either spouse has met the two-year requirement. (Note that the home may also receive a basis adjustment as a result of a decedent's death.)

A taxpayer is treated as owning and using property as the taxpayer's principal residence during any period that the taxpayer's deceased spouse owned and used the property as a principal residence before death, if the taxpayer's spouse is deceased on the date of the sale or exchange of the property, and the taxpayer has not remarried at the time of the sale or exchange [IRC Sec. 121(d)(2); Reg. §1.121-4(a)(1)].

IRC Sec. 121(b)(4) provides, if all other Section 121 requirements are met, an unmarried surviving spouse may exclude up to $500,000 of gain if such sale occurs not later than two years after the DOD of a spouse.

Salaries and Wages

Only amounts received prior to death are reported on a final return of a cash basis taxpayer. Earned but unpaid compensation at the DOD is reported as income in respect of a decedent (IRD) and is reported by the estate or trust:

1. *Reporting to estate or beneficiary.* Compensation received after death is not subject to income tax withholding. It should be reported on Form 1099-MISC in Box 3, using the tax ID number of the estate, trust, or successor in interest (e.g., surviving spouse or child).

2. *Reporting to deceased employee.* Compensation paid after death but during the same calendar year is subject to FICA and FUTA and is included on Form W-2, in Boxes 3 and 5 only.

3. *Reporting to deceased employee.* Compensation paid after death in a later calendar year is exempt from FICA and FUTA. These wages are reported on a Form 1099-MISC, Box 3 (rather than Form W-2).

Unpaid compensation at DOD would be reported as an asset of the estate, and when collected would constitute IRD.

NOTE: Form 4852 (Substitute for Form W-2, et. al.) should be used to correct information returns provided by payers that do not properly report amounts paid in the year of death.

IRAs and Other Retirement Accounts

Only amounts received prior to death are included as income on a decedent's final return. Amounts collected subsequent to death (e.g., year-of-death required minimum distribution) would constitute IRD and is reported as income by the recipient of the benefits.

IRS GUIDANCE: In PLR 8439066, the IRS ruled that a contribution made after the death of the account owner "would not be a contribution for retirement purposes." Or put another way, you cannot make a retirement contribution after you are dead.

However, in PLR 8527083, the IRS allowed a surviving spouse to make an IRA contribution to her spousal IRA after the death of the working spouse. See Chapter 16 for additional information.

Health Savings Account (HSA)

The treatment of an HSA depends on the designated beneficiary:

1. *Spouse.* If the spouse is the beneficiary, the account will be treated as the spouse's HSA.

2. *Non-spouse.* If the designated beneficiary is not the spouse, the account ceases to be an HSA, and the FMV of the HSA becomes taxable to the beneficiary in the year of the decedent's death.

NOTE: The amount taxable to the beneficiary is reduced by any qualified medical expenses paid by the beneficiary on behalf of the decedent within one year after the DOD [IRC Sec. 223(f)(8)(B)(ii)].

3. *Estate.* If a decedent's estate is the beneficiary, the FMV of the HSA is included on the decedent's final Form 1040.

Coverdell Education Savings Account (ESA)

The treatment of an ESA depends on who acquires the interest in the account:

1. *Decedent's estate.* Earnings will be included on decedent's final income tax return.

2. *Designated beneficiary.* If a family member is the designated beneficiary, then it becomes their account.

3. *Another beneficiary (not designated).* Beneficiary must include in income any earnings portion of a distribution. After a 30-day period, the account is deemed to be distributed. Any taxable amount is reduced by any qualified education expenses of the decedent paid within one year of death.

SPECIAL PROVISIONS REGARDING LOSSES AND DEDUCTIONS

Capital Losses and Net Operating Losses

A decedent's losses are deductible only on the decedent's final return [Rev. Rul. 74-175]. No carryover to the income tax return of the estate or the successor in interest is allowed [Rev. Rul. 74-175]. No carryover of a decedent's separate loss is available to a surviving spouse [PLR 8510053].

PLANNING TIP: If a married taxpayer is in failing health, opportunities to generate capital gain income should be taken to offset capital loss carryovers. After the DOD, the spouse can continue generating capital gain income for the remainder of the year to offset capital loss carryovers. The spouse can immediately repurchase any securities that were sold if they are deemed to be good investments, because the wash-sale rules don't apply to securities sold at a gain.

If a married taxpayer in failing health is holding property that would generate a capital loss, consider gifting it to the spouse before death. This will preserve the loss otherwise lost if the taxpayer died holding the asset. The cost basis of an asset gifted to a spouse is its original cost even when FMV is lower [IRC Sec. 1041(b)].

Passive Activity Interests Transferred Due to Death of the Taxpayer

Suspended losses are deductible on a decedent's final return to the extent they exceed the amount, if any, by which the basis of the interest in the activity is stepped-up to fair market value at DOD under IRC Sec. 1014. Suspended losses are eliminated to the extent of the basis step-up so there is no double benefit.

EXAMPLE: Treatment of suspended loss on decedent's final return

When Kevin passed away, he owned a rental property with an adjusted basis of $500,000, a FMV of $550,000, and suspended passive losses of $75,000. Kevin has no other passive income. The deductible suspended loss on Kevin's final return is limited to $25,000 ($75,000 suspended passive loss – $50,000 step-up in basis).

Note: If the property had declined in value, consider advising him to gift the rental property before he dies. The full $75,000 passive activity loss is added to the donee's basis [IRC Sec. 469(j)(6)] in the rental property. Even though the donee cannot use the suspended passive loss currently, none of the passive loss is permanently lost.

Depreciation

The deduction is computed using the short taxable year rules [Prop. Reg. §1.168-5(f)(4)]. A disposition *does not* include a transfer of property by reason of death of a taxpayer [IRC Sec. 1250(d)(2)].

Medical Expenses

Medical expenses paid before death are deductible on a decedent's final Form 1040 unless paid for with a tax-free distribution from an HSA. However, if medical expenses are paid by a taxpayer's estate within one year of the DOD, the executor can elect to have them treated as if they were paid when incurred and deduct them on the decedent's final Form 1040 [IRC Sec. 213(c)]. The price for the election is the estate must agree to waive the right to claim the deduction at any time for estate tax purposes.

REMINDER: The Consolidated Appropriations Act of 2021 permanently extended the threshold of 7.5% for medical expenses.

Deduct the medical expenses on the decedent's final income tax return and attach a statement and waiver (Form 706) to the decedent's estate tax return.

PLANNING TIP: Be sure to take medical expenses where it will be most tax efficient. If Form 706 reflects no tax, or there is no Form 706 required, take the expenses on the final Form 1040.

Medical expenses paid by a surviving spouse for the care of their deceased spouse are deductible on the survivor's income tax return in the tax year in which paid, whether paid before or after death.

Insurance reimbursements of previously deducted medical expenses due a decedent at DOD are includable as income on Form 1041 of the estate (or trust) or the tax return of the successor in interest.

Standard Deduction

The full amount of the basic and additional (if applicable) standard deduction is allowed regardless of DOD.

Unamortized Points

The unamortized balance of points is deductible in full on the final Form 1040 of a decedent [Rev. Rul. 86-67]

Unrecovered Investment in Pension

If a decedent was receiving a pension or annuity and died without a surviving annuitant, the amount of any remaining unrecovered investment in an annuity contract is deductible on the decedent's final return [IRC Sec. 72(b)(3)(A)]. The deduction is claimed as a miscellaneous itemized deduction not subject to 2% of AGI and is fully allowable for AMT. Any excess over the current year's income will create an NOL [IRC Sec. 72(b)(3)(c)].

ESTIMATED TAX PAYMENTS

Estimated tax payments are not required after DOD [PLR 9102010].

Joint Declarations

A joint estimated declaration *is not* allowed after the death of a spouse. The surviving spouse may file a separate estimated declaration to be applied to a joint return. If joint declarations are made, but separate returns are filed:

1. The parties may allocate payments in any manner as such parties decide.

2. If the parties fail to agree, the following special allocation method applies:

$$\frac{\text{Tax on survivor's separate return}}{\text{Tax on combined separate returns}} = \text{Percentage of estimated tax allocated to the survivor}$$

REQUEST FOR PROMPT ASSESSMENT FOR TAXES

A personal representative of a decedent's estate is responsible for seeing that any additional taxes owed are paid. The IRS usually has three years from the date a return is filed to assess additional taxes.

A personal representative can shorten the time the IRS has to assess a decedent's estate with any additional tax from three years to 18 months by requesting a prompt assessment of the decedent's income taxes [IRC Sec. 6501(d)]. The 18-month period begins on the date the IRS receives the request. Filing such request may permit a quicker settlement of the tax responsibilities of the estate and earlier distribution of the estate property to beneficiaries.

Requesting a prompt assessment does not shorten the time the IRS has for assessing tax if no return or a fraudulent return has been filed, or if the return includes a substantial understatement of income.

A prompt assessment is requested by filing Form 4810 [Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)] where the decedent's return was filed. Form 4810 must be filed separately from any other return and should not be filed until after the tax return listed on the form has been filed.

Taxpayers who do not want to use Form 4810 are permitted to make a request via a separate letter request. The letter request must be filed by itself and must clearly show [IRC Sec. 6501(d); Reg. 301.6501(d)-1(b)]:

1. That it is a request for prompt assessment under IRC Sec. 6501(d).

2. The kind of tax and tax periods.

3. The name and social security number or employer identification number shown on the return (copies of returns may be attached to help identify the return; write at top of return: "Copy-Do not process as original");

4. The date and location of the IRS office where the returns were filed; and

5. Verification of authority to act for the taxpayers, such as letters testamentary, letters of administration, etc.

WHERE TO GO FOR MORE INFORMATION

- IRS Pub. 559: *Survivors, Executors, and Administrators, Table B, Worksheet to Reconcile Amounts Reported in Name of Decedent on Information Returns (Forms W-2, 1099-INT, 1099-DIV, etc.)*

- Instructions to Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer

CHAPTER 43: FOREIGN INCOME, ACCOUNTS, AND CREDITS

Learning Objectives

Completion of this chapter will enable participants to—

- Determine and calculate the foreign earned income exclusion.
- Apply the foreign tax credit election [maximum of $300 ($600 for married filing jointly)].
- Identify foreign assets required to be reported on FinCEN Form 114 and/or IRS Form 8938.

WHAT'S NEW

1. Expanded waiver of residency requirements in Rev. Proc(s). 2020-14 and 2020-27.
2. New FBAR rules coming
3. Updated 2021 exclusions and limits.

FOREIGN EARNED INCOME EXCLUSION (IRC SEC. 911)

U.S. citizens and residents who live abroad are taxed on worldwide income. Qualified individuals can mitigate double taxation by excluding up to $108,700 for 2021 of foreign earned income ($107,600 in 2020) and exclude or deduct certain foreign housing costs.

The exclusion is limited to the smaller of $108,700 (for 2021) or the excess of the foreign earned income for the tax year over the foreign housing exclusion.

In the case of married taxpayers, the calculation is done separately for each. If both spouses work abroad and each meet either the bona fide residence test and/or physical presence test, then each can elect up to the full exclusion. Thus, it is possible for a married couple to exclude up to $216,400 in 2021 ($215,200 in 2020).

To qualify for a foreign earned income exclusion, a taxpayer must:

1. Earn foreign earned income. IRC Sec. 911(b)(1) defines this as the amount received by an individual from sources within a foreign country or countries which constitute earned income attributable to services performed by such individual (e.g., wages, salaries, or professional fees).
2. Be a citizen of the United States and bona fide resident of a foreign country or countries for an uninterrupted period (which includes an entire taxable year),or be a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period.
3. Be an individual whose tax home is in a foreign country.

PLANNING TIP: The term *tax home* means, with respect to any individual, such individual's home for purposes of IRC Sec. 162(a)(2) (relating to traveling expenses while away from home).

An individual shall not be treated as having a tax home in a foreign country for any period for which his abode is within the United States, unless such individual is serving in an area designated by the President of the United States by Executive order as a combat zone in support of the Armed Forces of the United States.

COURT CASE: In *Bellwood*, the Tax Court found that the retired U.S. Army pilot wasn't eligible for the Section 911 foreign earned income exclusion for income earned while working a 28-days-on/28-days-off schedule as a Saudi Arabia-based employee of a U.S. helicopter company that provided private air ambulance services in Saudi Arabia.

The Court determined the taxpayer didn't meet IRC Sec. 911's qualified individual requirements in that his tax home (abode) wasn't in, and he wasn't a bona fide resident of, Saudi Arabia for Section 911(d) purposes.

Notably, as to the tax home (abode) issue, it was clear that his tax home remained in the U.S. The taxpayer had only limited ties to Saudi Arabia, where his regular activities were primarily vocational, where he stayed in hotel rooms and an efficiency apartment paid for by his employer, and where he made only limited friends and made only occasional visits to local shops or restaurants. In contrast, he maintained strong ties in the U.S., where his wife and son resided, where he spent his off-duty days, where he owned a home, and where he retained citizenship, voter and vehicle registrations, driver's license, and primary doctors. Lastly, his employer made employment contingent on him retaining professional licenses in the U.S. and intended to eventually repatriate him to the U.S. for reassignment elsewhere. (*Bellwood v. Comm.*, TC Memo 2019-135)

Bona Fide Residence Test

To meet this test, a U.S. citizen (and in certain instances a resident alien) must show to IRS's satisfaction that he has been a bona fide resident of one or more foreign countries for an uninterrupted period which includes an entire tax year. Under general legal principles, *residence* has been defined as physical presence with an intention to live in a place for the time being.

The IRS defines *domicile* as the place to which the taxpayer always returns or intends to return when, for any reason, he or she goes somewhere else. In Publication 54, the IRS states that a taxpayer with a U.S. domicile (e.g., Ohio) may still have a bona fide foreign residence (e.g., Scotland).

The courts have established several factors when considering bona fide residence, including (not an exhaustive list):

1. Intention of the taxpayer,
2. Establishment of a home temporarily in the foreign country for an indefinite period,
3. Participation in the activities of the chosen community on social and cultural levels,
4. Assumption of economic burdens and payment of taxes to the foreign country, and
5. Nature and duration of employment.

EXAMPLE: Applying the bona fide residence test

Scenario 1: Philip arrived with his family in Paris, France, on November 5, 2020. His assignment is indefinite, and he immediately established a residence there. On April 5, 2021, Philip landed in the United States to meet with his employer, leaving his family in Paris. He returned to Paris on April 11 and continued to live there. On December 31, 2021, Philip completed an interrupted period of residence for a full tax year (2021) and satisfied the requirements of the bona fide residence test.

Variation: Assuming the same facts in Scenario 1 except that Philip transferred back to the United States on December 15, 2021. He no longer meets the bona fide residence test because his residence period did not include a full tax year. (Note that he may still qualify for Section 911 treatment using the physical presence test.)

Scenario 2: Keith was a bona fide resident of Haiti from March 1, 2019, through September 14, 2021. On September 15, 2021, Keith returned to the United States. Keith qualifies as a bona fide resident of a foreign country for the entire 2020 tax year. He also qualifies as a bona fide resident from March 1, 2019, through December 31, 2020, and from January 1, 2021, through September 14, 2021 .

Physical Presence Test

Under IRC Sec. 911, a U.S. citizen or resident whose tax home is in a foreign country and who, during any consecutive 12-month period, is present in one or more foreign countries during at least 330 full days, satisfies the *foreign physical presence* test. Rules for determining the 12-month period for meeting the test include:

1. The 330 days do not have to be consecutive.
2. The 12-month period can begin with any day of the month. It ends the day before the same calendar day, 12 months later.
3. The 12-month period must be made up of consecutive months. Any 12-month period can be used if the 330 days in a foreign country fall within that period.
4. Taxpayers do not have to begin a 12-month period with their first full day in a foreign country or end it with the day they leave. A taxpayer may choose any 12-month period.
5. In determining if a 12-month period falls within a longer stay in a foreign country, any 12-month period can overlap another.

EXAMPLE: Applying the physical presence test

Margie works for Radio Uno in Mexico for a 20-month period from January 1, 2020, through August 31, 2021. Margie spends March 2020 and March 2021 on vacation in the U.S. She is present in Mexico 330 full days during each of the following two 12-month periods: one period from January 1, 2020, to December 31, 2020; and a second period from September 1, 2020 ending August 31, 2021. The overlapping of periods allows Margie to meet the physical presence test for the whole 20-month period.

To meet the bona fide resident or physical presence test, a taxpayer must live or be present in a foreign country, usually any territory under the sovereignty of a government other than the United States.

Therefore, the term *foreign country* does not apply to Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the U.S. Virgin Islands, or U.S. possessions such as American Samoa.

The minimum time requirements for the bona fide residence test or the physical presence test can be waived [IRC Sec 911(d)(1)] if a taxpayer must leave a foreign country because of war, civil unrest, or other adverse conditions. The IRS publishes a list of countries qualifying for the waiver and the effective dates.

Three conditions must be met for the waiver to apply:

1. The individual actually must have been a bona fide resident of, or present in, a foreign country for a period of time.

2. Before he/she meets the time requirements for the foreign residence test or the foreign presence test, he/she must leave the foreign country during a period in which the IRS determines, after consultation with the State Department, that individual had to leave the foreign country because of war, civil unrest or similar adverse conditions in that country which prevented the normal conduct of business by those individuals.

3. He/she must establish to the IRS's satisfaction that he/she could reasonably have been expected to meet the time requirements, but for the war, civil unrest or similar adverse conditions.

Individuals who establish residency or are first physically present in the foreign country after the date that the IRS prescribes, but during the period for which the IRS determines that individuals were required to leave the foreign country, will not qualify for the waiver. (See IRC Code Sec. 911(d)(4).

NEW DEVELOPMENT: Rev. Proc. 2020-27 provides a waiver of minimum time requirements due to the COVID-19 pandemic.

For 2019 and 2020, for purposes of IRC Sec. 911(d)(4), the COVID-19 pandemic is an adverse condition that precluded the normal conduct of business as follows:

1. In the People's Republic of China, excluding the Special Administrative Regions of Hong Kong and Macau (China), as of December 1, 2019; and

2. Globally, as of February 1, 2020.

The period covered by Rev. Proc. 2020-27 ended on July 15, 2020 (unless an extension is announced by the Treasury and IRS)

To qualify for relief under this procedure, an individual must have established residency, or have been physically present, in the foreign country on or before the applicable date. Thus, an individual who was first physically present or established residency in China after December 1, 2020, or another foreign country after February 1, 2020, would not be eligible.

Individuals seeking to qualify for the foreign earned income exclusion because they could reasonably have been expected to have been present in a foreign country for 330 days but for the COVID-19 Emergency and have met the other requirements for qualification may use any 12-month period to meet the qualified individual requirement.

For example, an individual who arrived in China on September 1, 2019, and establishes that he or she reasonably expected to work in China until September 1, 2020 but departed China on January 10, 2020 due to the COVID-19 Emergency would be a qualified individual for the period September 1–December 31, 2019, and for the period January 1–January 9, 2020, assuming the individual has met the other requirements for qualification.

EXAMPLE: Determining whether time requirements due to the COVID-19 pandemic were met

Stan, an individual who was present in the United Kingdom on January 1, 202 through March 1, 2020, establishes that he reasonably expected to work in the UK for the entire calendar year, but departed the UK on March 2, 2020 due to the COVID-19 Emergency, and returned to the UK on August 25, 2020 for the remainder of the calendar year, would be a qualified individual for 2020 for the periods January 1–March 1, 2020, and August 25–December 31, 2020, assuming the individual has met the other requirements for qualification.

NEW DEVELOPMENT: In Rev. Proc. 2020-14, IRS listed five additional countries that have qualified for waiver of residency requirements under IRC Sec. 911(d)(4), including Democratic Republic of Congo, Haiti, Iraq, Sudan, and Venezuela.

Taxpayers elect the foreign income exclusion by completing appropriate parts of Form 2555. Generally, the initial election must be made on:

1. A timely filed return (including extensions).
2. A return amending a timely filed original return. Amended returns generally must be filed by the later of three years after the filing date of the original return or two years after the tax is paid.
3. A return filed within one year from the original due date of the return (determined without regard to any extensions).

An exclusion can still be taken for late-filed returns if:

1. No federal tax is owed after considering the exclusion, or
2. An individual owes income tax but files and takes an exclusion before the IRS discovers they failed to choose the exclusion. "Filed pursuant to section 1.911-7(a)(2)(i)(D)" must be printed at the top of the first page of the return, or
3. A taxpayer owes tax and the IRS discovers the failure. The taxpayer must request a private letter ruling under Reg. 301.9100-3 and Rev. Proc. 2020-1 to take the exclusion.

Foreign earned income *does not* include the following:

1. Pay received as a military or civilian employee of the U.S. government or any of its agencies. (John Francis O'Rourke v. Comm., TC Summary Opinion 2009-26)
2. Pay for services conducted in international waters (not a foreign country).

3. Pay in specific combat zones as designated by an Executive Order from the President that is excludable from income.

4. Payments received more than one year after it was earned.

5. Value of meals and lodging excluded from income because they were furnished for the convenience of the employer.

6. Pension or annuity payments including social security benefits.

Self-Employed Individuals

While a foreign earned income exclusion can reduce regular income tax, it does not reduce self-employment tax.

EXAMPLE: Treatment of foreign earned self-employment income

Geoff is self-employed in a foreign country and qualifies for the foreign earned income exclusion. Geoff's gross foreign income on Schedule C is $45,000 and his allowable business deductions are $10,000, resulting in a net profit of $35,000. Self-employment taxes must be paid on the net profit even though it is entirely excluded under IRC Sec. 911.

Part-Year Exclusion

If a taxpayer qualifies under either the bona fide residence or physical presence test for only part of a tax year, the taxpayer must adjust the maximum limit based on the number of qualifying days in the tax year.

FOREIGN HOUSING COST EXCLUSION OR DEDUCTION

In addition to the foreign earned income exclusion, qualifying individuals can also choose to exclude or deduct from gross income a certain amount of foreign housing costs.

The housing cost amount is generally limited to 30% of the maximum foreign earned income exclusion per IRC Sec. 911(c)(2)(A). The housing cost limitation is $32,610 (30% × $108,700) for 2021. IRS Notice 2021-18 provides for a higher amount in high-cost areas. For example, in lieu of the $32,610 general rule, qualified individuals in Rome and Moscow may use $50,800 and $108,000, respectively (see Notice 2021-18 for a detailed list).

PLANNING TIP: In addition to providing adjustments to the limitation on housing expenses under IRC Sec. 911, Notice 2021-18 further provides that some taxpayers may elect to apply the 2021 limitation for tax years beginning in 2020.

For some locations, the limitation on housing expenses provided in Notice 2021-18 may be higher than the limitation on housing expenses provided in Notice 2020-13 for 2020. A qualified individual incurring housing expenses in one of these locations during 2020 may elect to apply the adjusted limitation on housing expenses provided in Notice 2021-18, in lieu of the amounts provided in Notice 2020-13.

While high-cost area amounts for some cities remain unchanged from 2020 (e.g., Angola, Hong Kong, Rio de Janeiro), others increased significantly. For example, the amount for Sydney, Australia increased from $67,900 for 2020 to $74,000 for 2021.

After computing the maximum exclusion, a base amount is not allowed, equal to 16% of the maximum earned income exclusion [16% × $108,700 = $17,392]. This is subtracted from the amount calculated in the previous paragraph.

EXAMPLE: Calculating disallowed base amount from maximum income exclusion

Becca works in Hong Kong, China, for all of 2021. The annual limitation for Hong Kong is $114,300. Her maximum housing cost exclusion is $96,908 ($114,300 full year limit on housing expenses in Hong Kong per Notice 2021-18 minus $17,392 base amount).

Only the foreign housing cost amount that is attributable to employer provided amounts is excludable from gross income. The foreign housing cost amount that isn't attributable to employer provided amounts is allowed as a deduction in determining adjusted gross income, subject to limitation. The amount of the deduction is limited to the individual's foreign earned income for the tax year which isn't otherwise excluded from gross income under the foreign earned amount income exclusion and the foreign housing cost amount exclusion.

The deduction, plus the individual's foreign earned income and foreign housing cost exclusions, can't exceed their foreign earned income (total) for the year [IRC Sec. 911(d)(7)]. However, any excess housing cost amount deduction can be carried over, but only to the next tax year. Those expenses may then be deducted in that next year, but only to the extent that his foreign earned income for that year exceeds his foreign earned income exclusion, housing cost exclusion, and housing cost deduction for that year. Thus, the carried forward housing expenses can be used in that next year only after the housing expenses incurred in that year have been used.

To qualify for the foreign housing cost exclusion or deduction, a taxpayer must have a tax home in a foreign country and qualify for the foreign earned income exclusion.

The housing amount includes those housing expenses (e.g., rent, fair rental value of housing provided in kind by the employer, repairs, utilities, rental of furniture and accessories) which remain after subtracting the base amount. Housing amounts can be computed either separately or jointly if an employee and spouse live together, file a joint return, each have foreign earned income, and claim a foreign housing exclusion. Housing amounts are computed separately if separate returns are filed.

An election is made by completing appropriate parts of Form 2555. The time for making an election on Form 2555 is the same as making a foreign earned income election on Form 2555.

COMPUTING THE TAX

The amount of the foreign earned income exclusion and/or foreign housing exclusion is added back to income in order to determine a taxpayer's tax bracket. The income is not taxable, but it is used to determine what rate will apply to any taxable income the taxpayer may have [IRC Sec. 911(f)(1)].

The regular tax is equal to the excess (if any) of—

1. The regular tax that would be imposed for the tax year if the taxpayer's taxable income were increased by the amount of the exclusions for the tax year; over

2. The tax that would be imposed for the tax year if the taxpayer's taxable income were equal to the amount of the exclusions for the tax year [IRC Sec. 911(f)(1)(A)].

However, if the taxpayer's net capital gain exceeds taxable income for a tax year (i.e., there is a capital gain excess):

1. The taxpayer's net capital gain (determined without including any qualified dividend income in net capital gain) is reduced (but not below zero) by the capital gain excess.

2. The taxpayer's qualified dividend income is reduced by the portion of the capital gain excess that exceeds the taxpayer's net capital gain (determined without including any qualified dividend income in net capital gain) and the reduction under item 1. above.

3. Adjusted net capital gain, unrecaptured IRC Sec. 1250 gain, and IRC Sec. 28% rate gain are each determined after increasing the IRC Sec. 1(h)(4)(B) amount that is treated as capital loss for purposes of calculating 28% rate gain and unrecaptured IRC Sec. 1250 gain by the capital gain excess. Thus, the amount of the excess is treated in the same manner as an increase in the long-term capital loss carried to the tax year.

EXAMPLE: Calculating tax on foreign incomes

In Year 1, an unmarried individual has $90,000 of excluded income, a $5,000 gain from the sale of a long-term capital asset, $25,000 unrecaptured Section 1250 gain, and $20,000 of deductions. The taxpayer's taxable income is $10,000. The taxpayer's tax is the excess of the amount of tax computed on taxable income of $100,000 ($10,000 taxable income plus $90,000 excluded income) over the amount of tax computed on taxable income of $90,000 (excluded income). In determining the tax on the $100,000, the net capital gain is $10,000, of which $5,000 is adjusted net capital gain and $5,000 is unrecaptured Section 1250 gain. This results in a tax of $2,000 (15% of $5,000 adjusted net capital gain plus 25% of $5,000 unrecaptured Section 1250 gain).

WITHHOLDING TAX AND SOCIAL SECURITY ISSUES

Withholding from wages is generally required by any U.S. employer of a U.S. citizen performing services in a foreign country, unless under foreign law the employer is required to withhold foreign income tax.

Form 673, Statement for Claiming Exemption From Withholding on Foreign Earned Income Eligible for the Exclusion(s) Provided by Section 911, can be submitted by an employee to their employer, thereby relieving the employer of the requirement to withhold U.S. income tax from wages earned abroad.

Wages paid to U.S. citizens and resident aliens employed outside the United States are generally subject to social security and Medicare tax if the employer is an American employer (e.g., corporation organized under the laws of the United States or of any State or the District of Columbia).

The United States may enter into agreements with foreign countries to coordinate the taxation of social security for workers employed there to eliminate the dual taxation for self-employed taxpayers. These agreements are commonly called "Totalization Agreements." The list of countries is available at **www.irs.gov/individuals/international-taxpayers/totalization-agreements**.

FOREIGN TAX CREDIT

U.S. citizens are subject to tax on their worldwide income. To avoid double taxation, a nonrefundable foreign tax credit (FTC) is allowed under IRC Sec. 27.

PLANNING TIP: Taxpayers can treat the amount of foreign taxes paid as either a deduction from income (as an itemized deduction on Form 1040, Schedule A) or as a tax credit. The credit, providing dollar-for-dollar tax savings, is generally preferable to a deduction.

RECENT DEVELOPMENT: For tax years beginning after December 31, 2017, and before January 1, 2026, the aggregate deduction for state and local real property taxes, state and local personal property taxes, state and local, and foreign, income, war profits, excess profits taxes, and general sales taxes (if elected) for any tax year is limited to $10,000 ($5,000 for marrieds filing separately) [IRC Sec. 164(b)(6)(B)].

The amount of the foreign tax a taxpayer can use as a credit to offset U.S. tax liability is limited, based on the following formula [Reg. 1.904-1(a)]:

$$\text{U.S. tax (before credit)}^{a} \times \frac{\text{Foreign-sourced taxable income}^{b}}{\text{Worldwide taxable income}^{b}}$$

Notes:

[a] Line 16, Form 1040. Generally, regular tax only (i.e., does not include AMT, SE tax, or ITC recapture) reduced by any tax carried from Form 4972 (line 16, box 2 amount).

[b] Itemized deductions (or the standard deduction) generally are allocated to the numerator based on the ratio of foreign gross income to worldwide gross income.

The foreign tax credit may not exceed the portion of U.S. tax attributable to income from foreign sources. The limitation is calculated on Form 1116.

Form 1116 reports seven different categories of income. The two most common for individual taxpayers are—

1. Passive category income (box c) which includes interest, dividends, rents, royalties, annuities, and capital gains not related to the active conduct of a trade or business (i.e., unearned income) [IRC Sec. 904(d)(2)(B)]; and

2. General category income (box d) which is a catch-all category covering income not included in one of the others. It includes wages, salaries, overseas allowances, gains from sale of inventory or depreciable property used in a trade or business, and net income from foreign trade or business (i.e., earned income) [IRC Sec. 904(d)(2)(A)(ii)].

If the foreign taxes (eligible for the credit) paid or accrued in the current year exceed the limitation, the excess taxes are first carried back to the preceding year and then forward to the ten succeeding years

[IRC Sec. 904(c); Reg. 1.904-2]. There is no election to forego the carryback period. The excess taxes are considered paid in the year to which they are carried.

An individual with (1) no more than $300 ($600 for married filing jointly) of creditable foreign taxes, and (2) only qualified passive foreign income may elect to be exempt from the foreign tax credit limitation [IRC Sec. 904(j)].

Qualified passive income generally includes investment income such as dividends, interest, rents, royalties, and sale or exchange gains. The election is made by not filing Form 1116 and simply claiming the foreign tax credit on the appropriate line of Schedule 3 of Form 1040. Any unused credit cannot be carried back or forward if this election is made.

FOREIGN ACCOUNTS AND ASSOCIATED REPORTING REQUIREMENTS

Tax practitioners and the taxpayers they represent have long struggled with whether virtual currency—i.e., cryptocurrency—is reportable for purposes of FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR).

Normally, the value of fiat currency (i.e., U.S. dollars and other assets held by a foreign financial institution (FFI) on behalf of a taxpayer) is reportable on FinCEN Form 114 when the aggregate value of all offshore accounts exceeds $10,000 at any point during the tax year.

Treasury's Financial Crimes Enforcement Network (FinCEN) has stated that the regulations [31 C.F.R. §1010.350(c)] *do not* define whether virtual currency held in an offshore account is a type of reportable account. Therefore, virtual currency has not been reportable on the FBAR, up until as recent as June 2019. However, in late December 2020, FinCEN issued a notice (FinCEN Notice 2020-2) stating that it intends to propose amendments to regulations under the Bank Secrecy Act to specifically include a foreign account holding virtual currency as a type of account reportable under 31 C.F.R. Section 1010.350.

As stated, a foreign account holding virtual currency historically has not been among the types of accounts reportable under 31 C.F.R. Section 1010.350(c), and was therefore not required to be reported on FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR). However, this appears to be changing and very well may be the rule for 2021.

There are two statements requiring a response in the event a taxpayer reports more than $1,500 of interest and/or dividends on Form 1040, Schedule B:

1. At any time during the tax year did the taxpayer have a financial interest in or signature authority over a financial account located in a foreign country? If yes, a FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), may be required, and the name of the foreign country where the account is located may be required to be disclosed.

2. During the tax year did the taxpayer receive a distribution from, or was the taxpayer a grantor of, or a transferor to, a foreign trust? If yes, a Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, may be required to be filed.

FinCEN Form 114 (Report of Foreign Bank and Financial Accounts) is only available online through the BSA e-filing system website.

This is commonly known as an "FBAR" and is required of any U.S. person who meets certain requirements. The annual report must be electronically filed by April 15 (an automatic extension until October 15 applies).

PLANNING TIP: The Financial Crimes Enforcement Network (FinCEN), a bureau of the Treasury Department, issued a clarification providing that the 6-month filing extension is automatic (i.e., that specific requests for it are not required) and that this automatic extension will be granted each year to filers failing to meet the regular deadline.

Generally, an individual must file an FBAR for a reporting year if he is a U.S. person with a financial interest in, or signature or other authority over, a foreign bank, securities, or other financial account, and the aggregate amount in the accounts exceeds $10,000 at any time during the year.

A person who is required to file an FBAR and fails to properly file may be subject to a civil penalty not to exceed $10,000 per violation. If there is reasonable cause for the failure and the balance in the account is properly reported, no penalty will be imposed. A person who willfully fails to report an account or account identifying information may be subject to a civil monetary penalty equal to the greater of $100,000 or 50 percent of the balance in the account at the time of the violation. Willful violations may also be subject to criminal penalties.

RECENT DEVELOPMENT: In Program Manager Technical Advice 2018-013, the IRS set out the definition of willfulness and the standard of proof for establishing willfulness, for purposes of the penalty for willful violation of the requirements of the FBAR.

The IRS stated that "willful blindness is established when an individual takes deliberate actions to avoid confirming a high probability of wrongdoing and when he can almost be said to have actually known the critical facts." The government can show willful blindness by evidence that the taxpayer made a conscious effort to avoid learning about reporting requirements. The IRS stated that the courts are uniform with regard to the standard of proof for civil FBAR penalties: the government bears the burden of proving liability for the civil FBAR penalty by a preponderance of the evidence.

COURT CASE: In *Kronowitz*, CPA who prepared income tax returns for almost 60 years failed to file a FBAR for four accounts for 2005–2010, claiming that he had no knowledge that he was required to do so. After auditing the taxpayer, the IRS assessed penalties for a willful failure to file FBARs.

While the taxpayer argued that his failure was neither willful or reckless, the district court disagreed. In addition, the taxpayer was unable to convince the Court that his failure was due to declining health and memory loss upholding the penalties in excess of $663,000. [*Kronowitz, DC-FL 127,* AFTR 2d 2021-753, 6/3/2021]

COURT CASE: Between 2006–2009, Isac Schwarzbaum maintained several foreign financial accounts, including accounts in Costa Rica and Switzerland. Isac did not file FBARs for his accounts in Switzerland before 2011.

In 2011, Isac underwent full examinations of his returns for 2006, 2007, 2008, and 2009. After the examinations, the IRS decided to assert willful FBAR penalties against Isac. Those FBAR penalties (for tax years 2006–2009) were assessed in September 2016.

In March 2020, the Florida District Court determined that Isac willfully failed to file FBARs for 2007–2009 but that the government had erroneously computed the FBAR penalties. So the court ordered further briefing from the parties on the computation issue.

After the government submitted its recalculated FBAR penalties, Isac argued that the penalties totaling $12.9 million couldn't be collected because they violated the Excessive Fines Clause of the Eighth Amendment.

Subsequently, the district court found that the Excessive Fines Clause didn't apply to civil FBAR penalties because such penalties are not "fines" for purposes of the Eighth Amendment. [*U.S. v. Schwarzbaum*, 125 AFTR 2d 2020-1323 (DC FL) and 125 AFTR 2d 2020-2109 (DC FL)].

COURT CASE: In *Ott* [125 AFTR 2d 2020-1073 (DC MI)], the Michigan district court held that a taxpayer who failed to file an FBAR did so willfully. It came to this conclusion because, among other reasons, the taxpayer signed his tax return under penalty of perjury, told the foreign bank not to send correspondence to his address, and failed to consult with a tax expert regarding whether to report the foreign account. The FBAR penalties assessed against the taxpayer totaled $988,245.

Form 8938 (Statement of Specified Foreign Financial Assets) is required to be filed with a taxpayer's annual income tax return to report the taxpayer's specified foreign financial assets if the total value of all the specified foreign financial assets is more than the appropriate reporting threshold.

A Form 8938 is required in the following circumstances:

Filing Status	Lives In	Total Value of Specified Foreign Financial Assets on the Last Day of the Tax Year is Greater Than:	Total Value of Specified Foreign Financial Assets at ANY Time During the Tax Year is Greater Than:
Unmarried	US	$50,000	$75,000
Unmarried	Abroad	$200,000	$300,000
MFJ	US	$100,000	$150,00
MFJ	Abroad	$400,000	$600,000
MFS	US	$50,000	$75,000
MFS	Abroad	$200,000	$300,000

IRS Comparison Chart of Form 8938 and FBAR Requirements

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Comparison of Form 8938 and FBAR Requirements

More In File +

The Form 8938 filing requirement does not replace or otherwise affect a taxpayer's obligation to file FinCEN Form 114 (Report of Foreign Bank and Financial Accounts). Unlike Form 8938, the FBAR (FinCEN Form 114) is not filed with the IRS. It must be filed directly with the office of Financial Crimes Enforcement Network (FinCEN), a bureau of the Department of the Treasury, separate from the IRS.

Individuals and domestic entities must check the requirements and relevant reporting thresholds of each form and determine if they should file Form 8938 or FinCEN Form 114, or both. Form 8938 and Instructions can be found at About Form 8938. FinCen Form 114 and Instructions can be found through FinCen's BSA E-Filing System.

	Form 8938, Statement of Specified Foreign Financial Assets	***FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR)***
Who Must File?	Specified individuals and specified domestic entities that have an interest in specified foreign financial assets and meet the reporting threshold • Specified individuals include U.S citizens, resident aliens, and certain non-resident aliens • Specified domestic entities include certain domestic corporations, partnerships, and trusts	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold
Does the United States include U.S. territories?	No	Yes, resident aliens of U.S territories and U.S. territory entities are subject to FBAR reporting

Reporting Threshold (Total Value of Assets)	Specified individuals living in the US: • Unmarried individual (or married filing separately): Total value of assets was more than \$50,000 on the last day of the tax year, or more than \$75,000 at any time during the year. • Married individual filing jointly: Total value of assets was more than \$100,000 on the last day of the tax year, or more than \$150,000 at any time during the year. Specified individuals living outside the US: • Unmarried individual (or married filing separately): Total value of assets was more than \$200,000 on the last day of the tax year, or more than \$300,000 at any time during the year. • Married individual filing jointly: Total value of assets was more than \$400,000 on the last day of the tax year, or more than \$600,000 at any time during the year. Specified domestic entities: Total value of assets was more than \$50,000 on the last day of the tax year, or more than \$50,000 at any time during the tax year.	Aggregate value of financial accounts exceeds \$10,000 at any time during the calendar year. This is a cumulative balance, meaning if you have 2 accounts with a combined account balance greater than \$10,000 at any one time, both accounts would have to be reported.
When do you have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on your income tax return	Financial interest: you are the owner of record or holder of legal title; the owner of record or holder of legal title is your agent or representative; you have a sufficient interest in the entity that is the owner of record or holder of legal title. Signature authority: you have authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account. See instructions for further details.
What is Reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign non-account investment assets	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars.	Use periodic account statements to determine the maximum value in the currency of the account. Convert to U.S. dollars using the end of the calendar year exchange rate and report in U.S. dollars.

When Due?	Form is attached to your annual return and due on the date of that return, including any applicable extensions	Received by April 15 (6-month automatic extension to Oct 15)
Where to File?	File with income tax return pursuant to instructions for filing the return.	File electronically through FinCENs BSA E-Filing System. The FBAR is not filed with a federal tax return.
Penalties	Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply	Civil monetary penalties are adjusted annually for inflation. For civil penalty assessment prior to Aug 1, 2016, if non-willful, up to $10,000; if willful, up to the greater of $100,000 or 50 percent of account balances; criminal penalties may also apply

WARNING: The current penalties for failing to file FinCEN Form 114 are (1) if non-willful, up to $13,481 or (2) if willful (PMTA 2018-013), up to the greater of $134,806 or 50% of account balances; criminal penalties may also apply.

Chart of Foreign Assets and Whether They Are Reportable

Financial (deposit and custodial) accounts held at foreign financial institutions	Yes	Yes
Financial account held at a foreign branch of a U.S. financial institution	No	Yes
Financial account held at a U.S. branch of a foreign financial institution	No	No
Foreign financial account for which you have signature authority	No, unless you otherwise have an interest in the account as described above	Yes, subject to exceptions
Foreign stock or securities held in a financial account at a foreign financial institution	The account itself is subject to reporting, but the contents of the account do not have to be separately reported	The account itself is subject to reporting, but the contents of the account do not have to be separately reported
Foreign stock or securities not held in a financial account	Yes	No
Foreign partnership interests	Yes	No
Indirect interests in foreign financial assets through an entity	No	Yes, if sufficient ownership or beneficial interest (i.e., a greater than 50 percent interest) in the entity. See instructions for further detail.
Foreign mutual funds	Yes	Yes
Domestic mutual fund investing in foreign stocks and securities	No	No
Foreign accounts and foreign non-account investment assets held by foreign or domestic grantor trust for which you are the grantor	Yes, as to both foreign accounts and foreign non-account investment assets	Yes, as to foreign accounts

Foreign-issued life insurance or annuity contract with a cash-value	Yes	Yes
Foreign hedge funds and foreign private equity funds	Yes	No
Foreign real estate held directly	No	No
Foreign real estate held through a foreign entity	No, but the foreign entity itself is a specified foreign financial asset and its maximum value includes the value of the real estate	No
Foreign currency held directly	No	No
Precious Metals held directly	No	No
Personal property, held directly, such as art, antiques, jewelry, cars and other collectibles	No	No
'Social Security'- type program benefits provided by a foreign government	No	No

*Note - This table is current through the publication date. Please check the instructions for each form for information regarding any future developments.

WHERE TO GO FOR MORE INFORMATION

- IRS Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*
- IRS Publication 514, *Foreign Tax Credit for Individuals*
- IRS Interactive Tax Assistant tool "Can I Exclude Income Earned in a Foreign Country?"
- IRS FBAR Reference Guide
- BSA Electronic Filing Requirements for Report of Foreign Bank and Financial Accounts (FinCEN Form 114) (Release Date January 2017)
- IRS Foreign Account Tax Compliance Act (FATCA) resource page
- FBAR inquiries may submitted to **866-270-0733** or **FBARquestions@irs.gov**.

CHAPTER 44: U.S. ARMED FORCES PERSONNEL

Learning Objectives

Completion of this chapter will enable participants to—

- Identify tax issues specific to armed forces personnel.
- Determine whether a military retirement pension is taxable.

MILITARY PERSONNEL DEFINED

The term *military personnel* includes all uniformed services under the jurisdiction of the Secretary of Defense, Army, Navy, Marines, Air Force, Coast Guard, and members of the U.S. Coast and Geodetic Survey and National Oceanic and Atmospheric Administration. Armed Forces personnel on assignment to NATO or similar organizations are considered members of the U.S. Armed Forces (*Striker v. Comm.*, TC Memo 2015-248).

MILITARY RETURN BENEFITS

Automatic Extension of Time to File

Military personnel on duty outside the U.S. and Puerto Rico receive an automatic additional two months to file their federal income tax returns. No Form 4868 is required (attach a statement to the return showing the requirement is met). Interest on amounts due accrue from the regular date of the return.

An additional 4- to 3-month extension is available by filing Form 4868 no later than June. Notice 2012-41 extended this relief provision to civilian spouses of active duty personnel who accompany them and claim U.S. residency.

Members of the U.S. Armed Forces performing services in a combat zone as enlisted personnel or as warrant officers for any part of a month have all their military pay received for military service in that month excluded from gross income [IRC Sec. 112].

Civilian personnel serving in regions designated as qualified hazardous duty areas, although not a combat zone, as well as locations involved in direct support of military operations, also qualify for these benefits.

Combat zones change on an occasional basis. At the current time, there are four areas: the Sinai Peninsula, the Arabian Peninsula Area, the Kosovo Area, and the Afghanistan Area. Also, numerous direct support locations are included with each area and are included for tax exclusion, such as the Persian Gulf, Jordan, Yemen, Somalia, and Syria. These and other locations are all listed at **www.irs.gov/newsroom/combat-zones**.

Combat Zone Personnel

Deadlines for filing and paying tax are automatically extended for 180 days after the later of either the last day the individual served in a combat zone, qualified hazardous duty area, or contingency operation, or the last day of any continued qualified hospitalization for an injury from service in any of those areas or while performing qualified services outside a combat zone.

Military Retirement Payments

Although generally included in income, they may be excluded from gross income, with certain limitations, if they constitute amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces.

COURT CASE: In *Keeter*, Mr. Keeter received a head injury while training that lead to a seizure disorder. A year later he was placed on permanent disability and received an honorable discharge. He received disability retirement income from the U.S. Army and did not report it as income on his tax return. The IRS determined a deficiency based on the unreported income. The court rightfully agreed with the Veterans Administration's classification of the payment over that of the IRS. (*Keeter v. Comm.*, TC Summary Opinion 2017-36)

OBSERVATION: It should be noted that as a result of this decision the court agreed that it did not matter whether the disabled veteran was receiving their benefit from the VA or as part of service retirement plan. Obtaining a VA pension may take as much as 12 months, while a normal military retirement allowance is processed in 2–3 months. The disabled veteran is often counseled to obtain the non-VA pension; however, the court made it clear the longstanding VA exemption still applies. Determining if the veteran retirement is actually a disability plan as outlined by *Keeter* is critical.

IRA Contributions

Nontaxable combat pay is included in compensation for purposes of calculating IRA contributions. An individual with no income other than non-taxable combat zone pay can still qualify to contribute to either an IRA or Roth IRA. (See additional details in Chapter 16.)

Qualified Reservist Distribution

The 10% additional tax on early distributions does not apply to military reserve members who take an early distribution from a qualified plan if they were called to duty for more than 179 days or for an indefinite period. The distribution must be made no earlier than the date of the order or call to active duty and no later than the close of the active duty period. Additionally, they may be able to repay amounts withdrawn from a qualified plan to an IRA within two years after the end of their active duty period.

PRACTICE TIP: Repayments cannot be more than the qualified reservist distributions. The repayment doesn't affect the amount that can be deducted as an IRA contribution. If a qualified reservist distribution is repaid, the amount of the repayment is included with nondeductible contributions on line 1 of Form 8606, Nondeductible IRAs.

Earned Income Credit

Taxpayers can elect to treat nontaxable combat pay as earned income for EIC calculation purposes. If elected, the nontaxable combat pay is still nontaxable.

PRACTICE TIP: Calculate the credit with and without nontaxable combat pay before making an election. Whether an election increases or decreases the EIC depends on total earned income, filing status, and number of qualifying children.

Moving Expenses

Although the above-the-line deduction for moving expenses was temporarily suspended by the TCJA through 2025, a member of the Armed Forces of the United States on active duty who moves pursuant to a military order and incident to a permanent change of station may still complete Form 3903, Moving Expenses, and take the deduction (See Chapter 41 for more information).

The Post-9/11 GI Bill expanded education benefits to military personnel who have served at least 90 days after September 10, 2001, and are still on active duty, or are an honorably discharged individual, or were discharged with a service-connected disability after 30 days of active aggregate service.

The Military Spouse Residency Relief Act (MSRRA) provides protection to military spouses related to residency, voting, and taxes. When a service member leaves his home state in accord with military orders, the service member's spouse may retain residency in his home state for voting and tax purposes, after relocating from that state to accompany the service member. This gives the same privileges to the spouse as the service member has under the Service Member Civil Relief Act.

A taxpayer on qualified official extended duty in the U.S. Armed Services, the Foreign Service, or as an employee of the intelligence community may suspend for up to 10 years of such duty time the running of the five-year ownership-and-use period before the sale of a residence [IRC Sec. 121(d)(9)].

Armed Forces Reservists who travel more than 100 miles away from home in connection with duty may deduct unreimbursed travel expenses on Form 1040, Schedule 1 (Form 2106 will need to be completed also). The amount is limited to the amount the federal government reimburses its employees for travel.

U.S. Armed Forces personnel who die while on active service in a combat zone, or from injuries or illnesses received in a combat zone, or in direct qualifying support of military operations in a combat zone, have their income tax liabilities forgiven for the year of death and for any earlier tax year ending on or after the first day of service in a combat zone [IRC Sec. 692(a)(1); Reg. 1.692-1(a)(1)].

WHERE TO GO FOR MORE INFORMATION

- IRS Publication 3, *Armed Forces' Tax Guide*
- An extensive list of tax benefits for members of the U.S. Armed Forces is maintained at **www.irs.gov/individuals/military**
- U.S. Department of Veterans Affairs guidance on the Post-9/11 GI Bill is available at **www.va.gov/education/about-gi-bill-benefits/post-9-11**

GLOSSARY

ACCOUNTABLE PLANS. An employee expense reimbursement plan under which the employer does not report the reimbursed amounts to the employee as wages. The reimbursements made by the employer to the employee are not taxable to the employee.

ACCRUAL. Recognizing and reporting items in a time period prior to the period of receipt or disbursement, when all events have occurred to fix the right to receipt of the income or to establish the fact of liability.

APPLICABLE FEDERAL RATE (AFR). When interest rates issued monthly by the federal government and used, among other purposes, for imputing interest on below-market loans.

ADJUSTED GROSS INCOME (AGI). When all income of an individual filer from whatever sources derived less certain deductions allowed as defined in IRC Sec. 62. AGI is used as a threshold in Form 1040 individual income taxation to calculate eligibility (or phase-out of eligibility) for many deductions, credits, or taxability of specific types of income.

ALTERNATIVE MINIMUM TAX (AMT). A tax imposed as a backup to regular tax originally intended to ensure that higher income taxpayers paid their fair share of tax. AMT is separate from, but parallel to, regular tax, and a taxpayer pays the greater of regular tax or AMT.

ALTERNATIVE MINIMUM TAXABLE INCOME (AMTI). Taxable income plus or minus alternative minimum tax adjustments, plus alternative minimum tax preferences. It is used to determine AMT.

ANNUITY. A contract issued by an insurance company under which, for a fixed amount of investment, the investor will receive regular payment in the future.

CAPITALIZATION. Recording an expenditure as an asset because of its long-term character or benefit, often followed by deductions to record the using up (depletion, depreciation or amortization) of the asset over a period of time.

CHARITABLE REMAINDER TRUST. A trust as defined in IRC Sec. 664 into which the donor transfers property to which he or she, and any other named beneficiaries, retains an income interest for life (or a specified term of years not exceeding 20), with the remainder passing to the named charity or charities at the death of the last beneficiary (or the expiration of the term of years). The donor receives an immediate charitable income tax deduction for the actuarial value of the remainder interest.

COMPENSATION. Income received as payment for services rendered.

DEFERRAL. Recognizing and reporting items in a time period subsequent to the period of realization.

EARNED INCOME CREDIT (EIC). Calculated by multiplying earned income by a credit percentage. A taxpayer's number of children affects the calculation, and the credit is subject to income phase-out ranges so as to focus its benefits on low income individuals.

EMPLOYEE STOCK OWNERSHIP PLAN (ESOP). A defined contribution plan that is either a stock bonus plan or a stock bonus plan and a money purchase plan, into which the employer contributes shares of its own stock and invests primarily in qualifying employer securities.

FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA) TAX. FICA is the law that provides for Social Security and Medicare benefits. This program is financed by payroll taxes imposed equally on the employer and employee. The employer is required to withhold a percentage from each employee's gross wages for Medicare tax and a percentage of each employee's wages for Social Security tax.

FIDUCIARY. An individual or entity holding a position of trust or confidence. Used here in connection with trusts and estates.

FAMILY LIMITED PARTNERSHIP (FLP). A business structure that is a tax-effective means of shifting wealth to other family members.

INDIVIDUAL RETIREMENT ACCOUNT (IRA). A retirement account set up by an individual as a means of setting money aside for his or her retirement years.

INCENTIVE STOCK OPTION (ISO). An option to purchase stock of a corporation granted to an individual in connection with that individual's employment. An ISO plan must meet specifications of IRC Sec. 422.

ITINERANT. An individual having no "tax home," meaning that the individual lacks a regular place of business and a regular residence. Consequence is typically the inability to deduct business travel costs.

LEGACY. A gift of money or other property made by a decedent's will.

LAST IN FIRST OUT (LIFO). A method for valuing inventory such that the cost of inventory at the close of a period is calculated assuming that the inventory removed for the period was removed at current costs. This method, during a period of rising costs, results in a lower ending inventory and a higher cost of goods sold.

PASSIVE ACTIVITY. Passive activity is (1) any trade or business or income-producing activity in which the taxpayer does not materially participate and (2) all rental activities (subject to certain exceptions).

PHASEOUT RANGES. Income ranges in which certain deductions, credits, and personal exemptions are reduced and eventually eliminated altogether.

PRINCIPAL RESIDENCE. A taxpayer's primary residence that is eligible for gain exclusion if (1) owned for at least two of the previous five years and (2) occupied for at least two of the previous five years, based on the date of sale.

QUALIFIED PLAN. Pension, profit sharing or stock bonus trust plan that meets certain requirements pertaining to discrimination in favor of highly compensated employees.

SELF-EMPLOYMENT TAX (SE TAX). Self-employed persons are subject to Social Security tax on net earnings up to the amount of the Social Security wage base (as well as the Medicare tax on all net earnings). If a self-employed individual receives wages from an employer that are subject to Social Security tax, the amount of self-employment income subject to Social Security tax may be reduced. Self-employment tax is computed on Schedule SE.

SIMPLE TRUST. A trust which, generally, must distribute all income received during the tax year.

TAXABLE INCOME. AGI less the greater of the standard deduction or total itemized deductions, less personal and dependency exemptions.

TRANSFER TAX. Tax imposed on transfers of property by gift or death of the transferor. It is composed of the following: (1) estate transfer tax, (2) gift transfer tax, and (3) generation skipping transfer (GST) tax.

UNRELATED BUSINESS TAXABLE INCOME (UBTI). Income generated by a tax-exempt organization when it conducts a business activity not substantially related to its tax-exempt purpose. UBTI is subject to income tax.

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